Weekly Financial Review

www.kif.re.kr

Vol. 20, No. 15 (16 April 2011)

# Strengthening Depositor Protection by Improving Financial Company Liquidation Procedures*

Jae-Youn Lee

## Abstract

Deposit insurance schemes must retain credibility in order to achieve the desired goals of protecting small depositors and enhancing financial system stability. Although Korea's level of insurance coverage is in line with global standards, there is less confidence in the speed at which depositors in insolvent financial companies can resume transactions. Although the period of stays on deposit withdrawals for savings banks where there has been a suspension of business has been shortened, it is still longer than globally recommended standards. The US allows for deposit transactions within three business days, while the same figure is 20 business days in the EU, and is recommending deposit payments be allowed within seven days from November 30, 2013. Korea itself is putting in place an institutional mechanism capable of further shortening liquidation periods, allowing for a full transfer of contracts upon a suspension of business. For savings banks in particular, the Korea Deposit Insurance Corporation (KDIC) is able to take part in the Financial Supervisory Service's (FSS) balance sheet assessment for determining insolvency, and management improvement plans may be submitted for preliminary review prior to an order for corrective action. Going forward, business suspensions for insolvent savings banks should be shortened and the FSS and KDIC should work closely from the initial stages in order to carry out liquidation procedures more efficiently and expediently.

* *Opinions expressed are those of the author and do not necessarily reflect the official positions of the Korea Institute of Finance.*

KOREA INSTITUTE OF FINANCE

Following the recent suspension of business at Samhwa Savings Bank and several other large savings banks, depositors were unable to withdraw deposits, creating difficulties among some retirees in meeting basic living expenses and among small business owners in running their ventures. These difficulties damaged the credibility of the deposit insurance scheme and led to a temporary bank run. The Korea Deposit Insurance Corporation (KDIC) tried to respond by making provisional deposit payouts of 20 million won, but this measure was not sufficient. This paper looks at liquidation procedures for failed banks in developed countries and explains the necessity for and ways of shortening the business suspension period.

> Disallowing withdrawals for an extended period damaged trust in the deposit insurance system and led to a bank run.

## Building Credibility in the Deposit Insurance System

In protecting small depositors, the deposit insurance scheme plays the role of stabilizing the financial system and stemming the spread of problems at specific financial companies to healthy ones by preventing bank runs that can arise when financial companies become insolvent. Since deposit-taking institutions pay out deposits on a first come-first serve basis, they are vulnerable to bank runs as depositors scramble to withdraw their deposits upon signs of distress.

> A deposit insurance scheme must protect enough deposits to achieve its desired goals, and contract transfers and deposit pay-outs must be conducted without delays on withdrawals.

The deposit insurance scheme must have enough trust so that most small depositors do not withdraw their deposits upon signs of distress if it is to achieve the desired goals. This requires both that a sufficient amount of the deposits be protected, and that inconvenience to depositors is minimized by not disallowing withdrawals for a long period and by speedily either paying depositors or transferring contracts to another financial company. Further, gaining the trust of depositors requires that an insurance scheme allow for

payment of deposits at the appropriate point in time by being able to raise sufficient funds.

In January 2003, Korea switched from a blanket to a limited deposit insurance scheme, and ramped up the protection deposit coverage from 20 to 50 million won. This is about 2.3 times estimated per capita 2010 GDP of 20,000 USD, and proximate to the double per capita level recommended by the EU.

However, when eight savings banks received orders early this year to suspend operations, net withdrawals of 200-500 billion won occurred for several days, even in spite of the insurance scheme. This was attributable to the fact that the scheme has not gained much trust in terms of reopening deposit transactions.

In Korea, supervisory authorities determine whether a financial company has failed to meet requirements (i.e., capital adequacy ratio requirements) and orders suspensions of business. Liquidation procedures are then commenced upon the suspension of business and result in a freeze on deposit withdrawals for a considerable period, which creates difficulties for small business owners and inconvenience for individual depositors. For 16 savings banks that have had suspensions of business from 2003-2010, the period for deposit transactions to be reopened/insurance paid out and for contracts to be transferred to other savings banks were, excluding the case earlier this year of Samhwa Savings Bank, all over three months. The procedures took three months at three banks, four months at five banks, five months at four banks, and six, seven, eight, and nine months at one bank each.

In Korea, liquidation procedures for insolvent financial companies result in a freeze on withdrawals for a consi-derable period, which creates difficulties for small business owners and inconvenience for individual depositors.

Recently, the period for suspension of withdrawals is being shortened, as since 2005, the KDIC has set up bridge banks to which contracts are transferred upon the suspension of business at a savings bank. When there is

an insolvent savings bank, the KDIC reopens business through moving contracts to the bridge bank, which reduces inconvenience for depositors, but still takes at least three months.

## Overseas Liquidation Procedures for Insolvent Financial Companies

In the US, deposit payment and contract transfers for depositors of financial companies targeted for liquidation are causing less and less disruptions for depositors. The US Federal Deposit Insurance Act stipulates that deposit insurance payouts for insolvent financial companies and contract transfers are to be done “as expediently as possible”, with the goal of three days or less. Insured deposits are either transferred to healthy financial companies or paid out within three days of the commencement of liquidation. Thus, under the US FDIC Act's liquidation procedures, for insolvent financial companies closed on a Saturday, deposit withdrawals are allowed through the acquiring bank by Monday of the following week, minimizing the inconvenience to debtors.

The US allows customers to re-commence deposit transactions within three business days, while it is 20 business days in the EU, which has recommended deposits be paid out within seven days from November 30, 2013.

In the US, once a financial company is deemed to be insolvent, the FDIC Act allows for the submission of feasible liquidation plans ahead of any determination by supervisory authorities to close the financial company. Regulators must notify the FDIC of a decision on liquidation at least 90 days before closure, and if the FDIC is unable to find an acquiring bank within that period, deposits are then transferred to the bridge bank set up by the FDIC. It maintains its guarantee so that depositors and financial companies are not disturbed in terms of the search for an acquiring institution.

Since December 31 2010, the EU's Deposit Guarantee Schemes Directive recommends that deposits be able to be paid out within 20 business days when a deposit–taking company is declared bankrupt, and the UK has set a target of within seven days. In July 2010, the EU recommended shortening the period for paying out deposits to within seven days from November 30, 2013. Further, the EU guidelines recommend that supervisory authorities be allowed to determine if a bank cannot accept deposit withdrawals within five business days.

## Potential Measures for Korea

At present, the KDIC uses its deposit insurance fund to make provisional deposit payouts of 20 million won in order to reduce depositor inconvenience and funding conditions for savings banks where business has been suspended. However, when an insolvent savings bank is sold off or its contracts transferred, the acquirer must repay the KDIC for the provisional payments before restarting business. The provisional payments thus end up reducing the deposits of the savings bank in question, and in turn its value, and thus may make it difficult to sell off. However, for three bridge banks set up since 2003, it has taken a year and a half to two years to sell them off, and those set up from end-2008 through end-2009 are still having trouble being sold off.

## Reform Measures

In Korea, when a financial company becomes insolvent, contract transfers and deposit payouts need to be conducted as expeditiously as possible.

Existing regulations in Korea include a mechanism capable of shortening the liquidation period for insolvent financial companies.

Currently in Korea, there is a mechanism capable of shortening the liquidation period. According to Article 10, Clause 4 of the Act on the Structural Improvement of the Financial Industry, among the detailed steps provided for under Prompt Corrective Action, regarding an “order for full suspension of business, full transfer of business, full transfer of contracts, or full retirement of stock" are permitted where there is "an insolvent financial institution or cases recognized as having clear concerns on whether sound credit order and the welfare of depositors exists, and falling sharply below the standards on debt conditions under Clause 2." As a result, the suspension of business and transfer of contracts can take place at the same time. Currently, an order for suspension of business for a savings bank is accompanied by an order to increase capital within one month as a final chance for rehabilitation.

Further, when the FSS conducts a balance sheet assessment to determine whether a savings bank is insolvent, the KDIC is able to take part in order to be able to shorten the liquidation procedures. When an order to improve management is issued, the submission of a managerial improvement plan is requested before an order is given, which then involves a preliminary review by the managerial assessment committee. An assessment of the submitted plan is possible prior to an order for managerial improvement, which makes it possible to issue such an order at the same time as an order for transfer of contracts.

When Samhwa Savings Bank was ordered to suspend business this past January 14th, within about one month —February 18th— it selected a preferred bidder (Woori Financial Group), and allowed it to re-commence business from the end of March. This shows that an order to raise additional capital within one month was able to reduce depositor inconvenience and create less instability in the financial market. Therefore, the effectiveness of such orders deserves scrutiny that weighs the importance of shareholder rights, depositor protection, and financial market stability. Also, if it is not possible to transfer the contracts at the same as the suspension of business, setting up a bridge bank will be necessary.

Expedient and efficient liquidation procedures will require that the FSS and

KDIC work closely from the initial phase of determining insolvency. Further, for bankruptcies of other financial firms beyond savings banks, suspensions of business must be as short as possible to minimize inconvenience to depositors and to build trust in the deposit insurance scheme as a whole.

# Focus & Brief

April 25~April 29

■ **Policy Issue in Focus:** The Need to Boost the Share of Installment-Type Funds

■ **News Briefs:**
- Central Bank Reports 1st Quarter GDP Figures for Korea
- Credit Card Loans Skyrocketed in 2010
- Foreigners' Equity Holdings Soared in 2010
- FSS, Bank of Korea to Conduct Joint Review on FX Soundness

■ **Market Indicators:** April 25~April 29

## □ Policy Issue In Focus:

**The Need to Boost the Share of Installment-Type Funds**

(Ray Hyungjoon Lim, Research Fellow)

■ **Overview:** Mutual funds may be classified as either lump-sum or installment-type, with the latter divided into either flexible or fixed. Following a mutual fund boom in 2007 in Korea, installment-type equity funds have made up 51% of assets, and 37.5% of overseas equity fund assets. The under-representation of installment-type equity funds has been especially pronounced among funds sold by securities and insurance companies: while 62.3% of equity funds sold by banks are installment-type, the same figure is 37.7% and 16.9% for securities companies and insurance companies, respectively.

■ **Current Status:** Installment-type funds possess risk management advantages for those with longer investment horizons, and the use of such funds should thus be encouraged for individual investors aged 25-40. When investing in installments, equities are purchased at each installment period's present stock prices and exchange rates, which allows one to be able to hedge naturally against stock volatility and exchange risk.

From January 2007 through February 2011, the KOSPI Index and won/dollar exchange rate gyrated wildly as Korea went through the global financial crisis. Investing over this period using an installment-type fund allowed investors to purchase domestic and overseas stocks at the overall period average exchange rate. Considering that most mutual funds aim for higher risk-adjusted long-run returns through diversification, investors who have decades before retirement should strongly consider installment-type funds.

■ Outlook: With banks already selling most of their funds as installment-type, securities companies will have to show greater commitment. Securities companies need to realize that such funds can pave the way to generating more stable earnings by building lasting relationships with customers. At present, securities companies' wealth management services focus on one-off sales of financial products. Establishing reliable earnings streams, however, will demand that they commit to providing relationship-centered wealth management services through sales of installment funds that can assist customers with long-term, comprehensive financial planning.

## □ Policy & Industry News Briefs: April 25~29

### ■ Central Bank Reports 1st Quarter GDP Figures for Korea

Korea's first quarter GDP rose 4.2% year-on-year and 1.4% over the previous quarter, according to preliminary estimates from the Bank of Korea. The Bank attributed the better than expected GDP figures, which represented the ninth straight quarter of positive GDP growth for Korea, to soaring exports, but indicated that worsening terms of trade from rising oil prices and exchange rates could actually result in a deterioration in household purchasing power. Related to this, the Bank also bumped up its inflation forecast for 2011 from 3.5% to 3.9%.

■ Foreigners' Equity Holdings Soared in 2010

According to the Financial Supervisory Service (FSS), foreign investors held 386.4 trillion won in domestic listed equities at the end of 2010, a 30.5% jump over the previous year. 186 trillon, or 48.3% of this amount, was held by investment companies, with other significant shares held by banks (13.3%) and pension funds (89.9%). US investors held the largest share, at 88.7 trillion won, followed. Foreign investors, meanwhile, increased bondholdings by 31.4% last year to 74.2 trillion won, led by the US, Luxembourg, and Thailand, all with roughly 11 trillion won in bonds each.

■ FSS, Bank of Korea to Conduct Joint Review on FX Soundness

The FSS and the Bank of Korea announced they will conduct a joint review of foreign exchange conditions to assess the fulfillment of the 'Measure for Reducing Capital Flow Volatility'. The review shall examine the FX forward positions of major banks that may affect FX soundness, focusing specifically on the increase in positions from overseas non-deliverable forwards (NDFs) and on whether. Authorities stated that, in contrast to the beginning of the year, scrutiny would be given as to whether speculative transactions –for instance, involving the aforementioned NDFs– may be strengthening the currency and pushing up short-term external debt positions.

## □ Market Indicators: April 25~April 29

| | | 2010 Avg. | March Avg. | April 25 | April 26 | April 27 | April 28 | April 29 |
|---|---|---|---|---|---|---|---|---|
| Interest Rates (%) | Call Rate (1d) | 1.97 | 2.92 | 3.02 | 3.02 | 3.01 | 3.01 | – |
| | CD Rate (3m) | 2.63 | 3.35 | 3.41 | 3.42 | 3.42 | 3.42 | 3.42 |
| | Industrial Bonds (1yr) | 3.38 | 3.74 | 3.79 | 3.79 | 3.79 | 3.78 | 3.77 |
| | Corporate Bonds (3yr, unsecured·AA–) | 5.81 | 4.28 | 4.62 | 4.61 | 4.64 | 4.58 | 4.56 |
| | KTBs (3yr) | 4.04 | 3.74 | 3.84 | 3.82 | 3.82 | 3.79 | 3.77 |
| | Nat'l. Housing Bonds (5yr) | 5.10 | 4.57 | 4.34 | 4.33 | 4.33 | 4.30 | 4.27 |
| KOSPI (100 million won) | KOSPI (January 1, 1980 = 100) | 1,764.99 | 2,002.67 | 2,216.00 | 2,206.30 | 2,206.70 | 2,208.35 | 2,192.36 |
| | Trading Value | 56,077 | 68,154 | 81,432 | 114,697 | 132,420 | 105,174 | 112,552 |
| | Investment Balance | 136,858 | 151,771 | 173,063 | 171,011 | 173,9978 | 170,382 | – |
| | Foreigner Net Purchases | 859 | 526 | 12,552 | 7,904 | 68,024 | 884 | 7,293 |
| Exchange Rates | Won/Dollar | 1,276.18 | 1,121.04 | 1,081.30 | 1,086.30 | 1,079.50 | 1,071.20 | 1,071.50 |
| | Won/Yen | 1,363.83 | 1,372.59 | 1,323.18 | 1,326.86 | 1,323.73 | 1,313.71 | 1,314.08 |
| | Won/Euro | 1,773.65 | 1,570.97 | 1,573.72 | 1,593.82 | 1,602.41 | 1,588.05 | 1,588.50 |

Edited and Translated by Thomas Steinberger