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TO: AMERICAN AUTOMOBILE MANUFACTURERS' ASSOCIATION

FROM: KROLL ASSOCIATES (ASIA) LIMITED

RE: RESEARCH PROJECT - KOREA
PHASE TWO ANALYSIS REPORT

DATE: 6 August, 1997

## PROPRIETARY INTERESTS STATEMENT

This report was prepared by Kroll Associates (Asia) Limited at the request of the American Automobile Manufacturers Association (AAMA) pursuant to the Research and Consulting Agreement between the AAMA and Kroll Associates (Kroll), dated 9 June 1997.

In accordance that that Agreement, AAMA shall have the right to use all Data compiled in the current Phase of the Assignment and contained herein for any purpose deemed suitable by AAMA and to identify Kroll in connection therewith.

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## CONTENTS

### *Assignment*

Kroll Associates (Asia) Limited ("Kroll") was instructed by the American Automobile Manufacturers Association ("AAMA") pursuant to a 'Research and Consulting Services Agreement' dated 5 June 1997 and Kroll's 'Proposed Consulting Assignment - Korea' dated 27 May 1997, to conduct research on the subject of Korean government preferential treatment of the Korean automotive industry.

Central to Kroll's research is an exegesis of relevant issues identified by Wilmer, Cutler and Pickering ("W,C&P") as listed in a memorandum entitled 'Financing the Korean Auto Industry Expansion - Points on which Information is Necessary', provided by John Greenwald, esq. at a meeting on 5 June 1997.

Phase One of Kroll's assignment consisted of a review and analysis of information previously gathered by the AAMA. This review was intended to serve as the 'jumping off' point for Kroll's research. Phase Two of the assignment involves and exegesis of information of a mainly public nature from the collection, collation and analysis of all relevant public and industry information..

This report consists of an analysis of information presented in the Phase One and Two Report presented in accordance with the schedule of issues outlined in the WC&P Memorandum with additional issues outlined in subsequent correspondence.

## A. KOREAN GOVERNMENT REGULATION OF THE FINANCIAL SECTOR

### 1. Information on Financial Sector Regulation and Post-1993 Liberalization

**a. How much real liberalization has there been?**

Looking at this question from the point of view of the whole rise of Korean industry and the government's role therein (the sources of which are plentiful), the answer would have to be that there has been a very significant amount of real liberalization. There have been an inordinate number of 'Plans' and announcement concerning 'deregulation', 'liberalization' and 'internationalization', some of which appear to have overlapping aims. These show what must be considered real and legitimate intentions with some real effects.

Regarding interest-rate deregulation, it would appear that liberalization took form in 1991 with the 'four-stage plan' (ref. Appendix 1).

Government plans to open the capital market date back to 1981 with a 'Long-term Plan for Internationalization whose steps are as follows:

* (1981 - 1984) - Allowing indirect securities investment by foreign investors while fostering the ability to absorb foreign capital inflow

* (from 1985) - Limited allowance of direct foreign investment in domestic securities

* (late 1980s) - Permission for direct foreign investment in domestic securities, with some limits

* (early 1990s) - Full-scale liberalization of Korean capital market, including domestic investment in foreign securities (ref. Appendix 2)

Following on from here, the government introduced a 'Three-Stage Liberalization Plan' in 1992 for full opening of the Korean financial market to foreign investors. (ref. Appendix 2).

In 1993, the government introduced a Five-Year Economic Plan with the stated intention of minimizing government intervention, stimulating competition and restructuring the financial system to follow a more western model (ref. Appendix 3).

From October 1996, when Korea became the 29th member of the OECD, the government announced further liberalization measures for the near future:

* (1998) - permitting foreigners to acquire non-guaranteed convertible bonds issued by companies other than small and medium-sized companies

* (1998 - 1999) - further expanding the opening of the Korean debt securities market to foreigners particularly with respect to non-guaranteed long-term bonds

* full liberalization of the scope of foreign investment in Korean debt securities about the time that the differences between domestic and international interest rates become less than 2.00%, or certain macro-economic measures indicate stability in the Korean economy (eg. inflation rate falls to 3.00% or lower)

(Note: One analyst commented that this is unlikely in the next decade).

* increasing the aggregate foreign ownership limit generally by 3.00% in each of 1997, 1998, 1999 and abolishing such limit in 2000

* increasing the ownership limit by a single foreigner up to 10.00% by 2000 (ref. Appendix 4)

(Note: A fuller chronology of events in the banking and auto industries from 1990 to 1997 is included as Appendix 4a).

Recent bankruptcies in Korea appear to have accelerated the government's desire to introduce financial reform measures. A Presidential Committee on Financial Reform is scheduled to table a report to the National Assembly in summer 1997. (ref. Appendix 5)

The following chart outlines the various measures under discussion:

**The Liberalization Plan Extensively Incorporates The Reform Proposals As Prepared By The Presidential Commission**

**Interest Rate Liberalization**

- Free withdrawal savings deposits which account for 25% of total deposits
- Interest rates on repurchasing agreements
- Removal of regulations of brokerage commissions
- Abolishment of interest rate limits of commercial loans to facilitate the inflow of foreign borrowing

**Financial Institutions**

- Securities companies will be allowed to deal in commercial paper
- Merchant banks will be permitted to handle stock underwritings
- Established credit limits for an entire chaebol (from credit limits on a single borrower)
- Categorization of different types of non-performing loans
- Increased transparency on consolidated financial statements

**Improved Access To Capital Markets**

- Double the ceiling on borrowing overseas commercial loans used to purchase Korean-made facilities from US$4b (from US$2b)
- Removal of limits on credit evaluations of foreign exchange bonds
- Increased allowance in venture capital financing
- Introduction of corporate pension scheme
- Measures to facilitate the disposition of non-performing assets
- Standards for disclosure of bad loans

Source
Korea's Structural Reform: Current Issues And Future Prospects 7/30/97 (41govt txt p5)
Jinro's Clutch Loan Extension Dampens Korea's Bailout Idea 7/30/97 (41bank txt p4)

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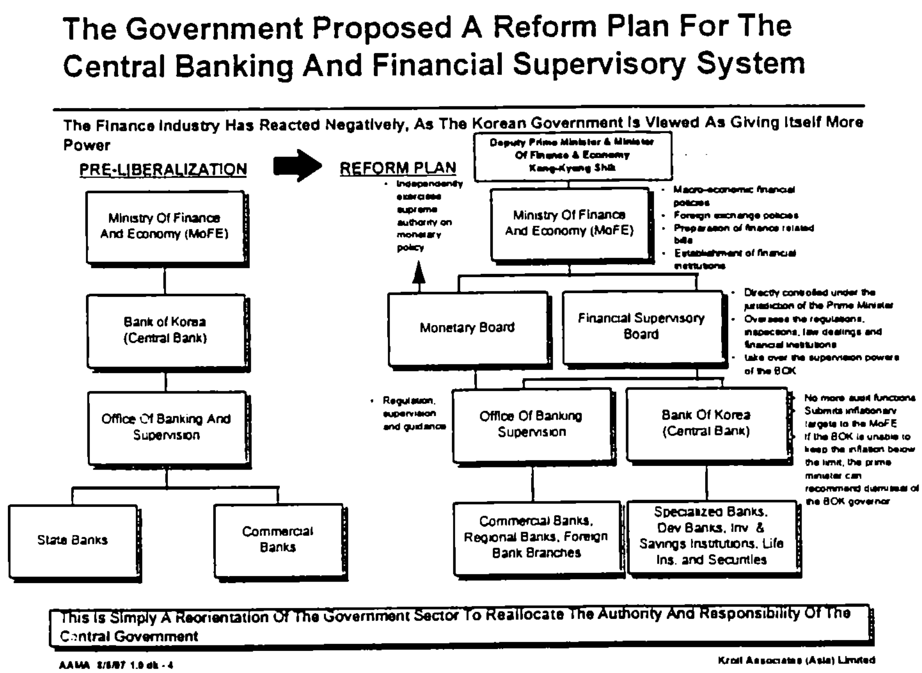
The subject of liberalization of the financial sector means, by definition, that the government's role is reduced. A critical analysis of these measures, however, shows that ultimately, the government maintains a tight rein on the financial sector and that, aside from specific improvements in, for example, access to overseas capital, relaxation in interest rates, wider access for FDI and other measures, the government maintains ultimate control over all of these.

Liberalization of the financial sector, therefore, does not mean less government control - these are separate issues and in the context of the current reform plans, one does not lead to the other. This view is supported by various comments from analysts. One reference to this issue refers to the negative reaction by the finance industry as the government is viewed as giving itself more power. One banking analyst stated that the government has taken all audit functions away from the Bank of Korea, making the MoFE that much bigger. (ref. Appendix 6)

The following chart depicts the general situation as it existed previously and, by comparison, the situation as it is presented today.




The latest media word on this issue, from the August edition of Asiamoney magazine, is that some senior staff members at the BOK have expressed the hope that, in time, the government might slowly grant the central bank a wider ranging mandate. It is in the interest of the public to have financial supervision away from politics, they said. Apparently the government does not share their view.

### b. What mechanisms does the Government use to funnel financing to favored sectors?

With the First Five-Year Economic Development Plan in 1962, an extensive reorganization of financial institutions was undertaken for the purpose of supporting development through more efficient allocation of banking funds. In 1961, a major portion of equity capital of commercial banks was transferred to the government. The Bank of Korea Act was amended in 1962 to strengthen government influence over monetary policy of the Bank (and continued government domination of the Monetary Board maintains this influence), the specialized banks were introduced to facilitate financing of underdeveloped or strategically important sectors (eg. Agriculture, Fisheries, Small and Medium Enterprises, Livestock, Housing) - these banks are directly supervised and operated by the government and 'funnel' financing to selected sectors. (ref. Appendix 7)

Much has been written about the dramatic rise of Korea as an industrial 'dragon' and the heavy government regulation and direct involvement in this rise - targeting of exports through subsidies and incentives for companies to move into export businesses, preferential access to cheap credit etc. Earlier industrial policies in relation to heavy and chemical industries are the model by which the system of preferential treatment operated.

There was, however, a change that had to be made in the late 1970s when, in the face of wage increases, increasing foreign debt, inflation, a number of HCI failures, the government was forced to moderate the industry-specific HCI policies in favor of promoting 'activities' rather than 'industries'. The changes included focusing on bailing out insolvent companies, reducing policy loans, eliminating some of the incentives available to HCI projects. Further the government took steps to liberalize imports and introduced the Fair Trade Act in 1981 and a five-year tariff-reduction plan in 1984.

What makes it difficult to say whether these measures were ever really introduced or, if they were, whether or not they were effective, is that industry-specific policies were maintained, and the automotive industry's X-5 and XC-5 policies are highly relevant examples, policy loans continued officially until 1995 and, according to most commentators, persist. Further clouding of these issues comes from the government's vociferous denials that preferentiality continues, as the MoFE Minister's recent statements in relation to the Kia bailout exemplify.

There is a direct relationship to the facility investment loans to industries and government development policy. The main lender for such investment, the KDB, is effectively controlled by the government and, statements about its diversification into trusts, securities and international investment banking aside, it still performs the same task as at its inception: the financing of economic development projects. Channeling of its loan funds parallels directly the government's policies of developing export-oriented businesses like electronic power generation, coal mining, shipbuilding (in the 1960s), HCI industries (1970s), and parts and components industries, high-tech industries, R&D projects for developing new technologies in the 1980s.

The government has channeled loan funds to favored industries through the KDB directly by being the source of borrowings and capital subscriptions, later through access to the National Investment Fund. In addition, of course, the KDB raises funds through the issue of Industrial Finance Debentures in both the domestic and international markets,

The government has the same relationship with the Export-Import Bank of Korea and the description of its role in financing Korean industry is effectively the same, with the inclusion of borrowings from the Bank of Korea to the government and foreign financial institutions as sources of funds in addition to its own issue of debentures and sale of promissory notes.

The Bank of Korea is also a source of funds for the commercial banks, although this is becoming less the case as liberalization proceeds.

**c. To what extent does the Government control the central bank?**

Bank of Korea is not independent of the government. From the perspective of the personnel, with main decision making responsibility, the role of the government is manifest. For example, the Minister of Finance and at least one of his appointees sit on the Monetary Board and other government ministers recommend four others (out of a total of nine members); the governor of the bank is appointed by the President on the recommendation of the Minister of Finance and Economy.

As cited above, the reforms to the financial system that are being made commensurate with the Presidential Commission on Financial Reform have effectively placed even greater control in the hands of the government. The impression gained from this is that, not only has some of the power been taken from the bank but that, through the Financial Supervisory Board, another layer of oversight and control has been placed over the bank's operations.

As the Reform Commission's report has yet to be tabled with the National Assembly, however, and any changes have yet to be put into practice, it is too early at the time of reporting to make concluding comments. Kroll considers that there will be a lot of attention placed on this subject in the ensuing weeks by the media and industry analysts. Central to such attention should be a critical review of the government's role in the financial system. This offers an opportunity for greater research by Kroll and, as this is central to the current assignment, we consider that this should be an issue for further attention.

**d. To what extent does the Government control the commercial banks?**

The Monetary Board of the Bank of Korea issues 'orders, instructions and regulations' to the commercial banks but, by and large under the law, commercial banks operate under the General Banking Act. Commercial banks obtain loans from the Bank of Korea to cover shortages in their own loanable funds. Whereas these conditions disclose no formal and functional role for the government per se, the environment in Korea is such that more seems to occur in the informal operations of banks. Many commentators refer to "the phone call" as a primary vehicle for interference in lending decisions, and the former head of Korea First Bank gave initial testimony to this practice in the investigation of Hanbo Steel's collapse. (ref. Appendix 8)

Kroll's opinion on this subject is that, whereas much more information and analysis could be made of the regulatory environment surrounding commercial banking operations, the pertinent question of 'actual' government influence over lending policies will not be adequately answered through that analysis, especially in relation to preferentiality to the automotive industry, as it seems likely that the most crucial decisions are made without reference to policy and in private.

**d. To what extent does the Government control the specialized banks?**

As stated above, the specialized banks are, by charter, controlled by the government with the specific aim of channeling funds to sectors deemed strategic and unable to raise finance independently.

In relation to the automotive industry, the bank which would most likely be involved in funding is the Industrial Bank of Korea (IBK), formerly named the Small and Medium Industry Bank.

At present, the government owns 64.5% of IBK, although it was reported in May 1997 that the government intends to privatize the IBK, and KDB, from July this year. At the time of writing, however, Kroll is not aware that this is being implemented according to schedule. In so doing, the government plans to change their classification for government-invested financial institutions to government-contributed ones, where government-invested institutions are directly controlled by the government in making major decisions.
*(Ref. 'Govt. to Privatize IBK and KDB Beginning July', Korea Economic Daily, 05/13/97)*

One analyst interviewed by Kroll specifically referred to specialized banks as being a source of funding for auto industry, although no details were forthcoming. This is considered to be an avenue for further enquiry, involving an attempt to obtain details of lending by the Industrial Bank of Korea to identify auto sector loans and, ipso facto, clear indications of government 'channeling' of funds.

**e. What are the incentives used by the Government to 'encourage' commercial bank cooperation?**

This question can perhaps be answered in part by a comment resulting from the formation of the anti-bankruptcy pact:

In the words of one banker: *"We decided to take the united action on the view that companies and we, creditor banks, are riding on the same vessel."* Clearly, the impression meant to be conveyed here is that the initiative is the banks. One reporter, however, believes otherwise: " *The government has come up with some solutions. Among them: more intervention. A Bankruptcy Prevention Accord drawn up in May asks financial institutions to help cash-strapped firms by not calling in their loans until a restructuring has been completed. It is supposed to be voluntary, but lenders were told that those who refused to sign up may be the subject of special probes into the way they do business. Complains an executive of a merchant bank: "The objective is to facilitate restructuring without forcing the company to go belly up. But this has distorted the market as the creditors are dictated to by the government".*

*('Bankruptcies: Going Under in Korea: Can Seoul Stanch The Corporate Bloodletting?' AsiaWeek By Laxmi Nakarmi Seoul - 06/13/97)*

This is an unequivocal statement indicating that the government was, indeed, involved in the formation of the pact and it goes further by declaring that the government effectively threatened banks to follow suit. Kroll's view is that this is entirely consistent with the 'strong-hand' approach which appears to typify the Korean government.

Regarding lending decisions, analysts used the expression 'window guidance' to refer to bureaucrats strong-arming banks into making loans to pet projects, and they say that this practice made a return last year after an absence of some years, referring in part to Hanbo Steel, because chaebols were pressing the Presidential Palace to force banks to get them out of lean times.

**f. Is the Bank of Korea discount window used to encourage commercial bank cooperation?**

The operation of the discount window by the Bank of Korea appears to be a subject which is not widely discussed, and certainly appears to be glossed over the official publications, where information about the BOK's dealings with banks merely state that it makes loans to banks, conducts credit operations in the form of rediscounts and loans with maturities up to one year and, as a lender of last resort, extends exceptional loans in periods of emergency when monetary and banking stability is directly threatened.

'Window guidance' is clearly a euphemism based on the concept of the discount window and reference has been made to the informal practices there. Kroll considers that further research is warranted into the operation of the discount window as, almost by definition, there are implications of preferentiality in the event that it could be shown that the BOK provided discounted loans to commercial banks in respect of loans to the automotive industry.

## 2. Policy Objectives Served by Financial Sector Regulation

a. What are the policy objectives of the Government's control over the financial sector?

This question must be seen in light of the efforts towards liberalization of the financial sector where, in short, the policy is to move towards a 'modernized', market driven economy. The plethora of reforms, deregulation, internationalization and liberalization measures, some of which have been cited earlier, point towards a country which is very quickly moving in that direction.

This subject is 'darkened', however, by the impression that, whatever reductions in credit restrictions, freeing of interest rates, opening of capital markets etc. that are being made and applauded, the government is not relinquishing 'control' over the sector. To that end, the government declares its intention to minimize the adverse effects of liberalization, like the possibility of foreign takeovers of domestic firms, disruption of the capital market, excessive outflow of funds.

**b. Does the Korean Government rely on financial sector regulation to maintain control over Korea's exchange rate?**

The degree to which the government uses regulatory measures to control exchange rates is a subject on which Kroll does not have sufficient information to offer a reasoned opinion. As this would shed light on the degree to which the government 'interferes' in the financial markets to create a positive export environment, however, Kroll considers that further research is warranted on this subject.

**b1. Were the restrictions on capital inflows imposed in 1987, at the time Korea's current accounts had moved in surplus figures, designed to protect against a rise in the won/dollar exchange rate; if not, what was their purpose, how long were the restrictions in force, and did they accomplish anything?**

Clearly, a current-account surplus places upward pressure on the value of the won and continued capital inflow adds to that pressure. Restricting capital inflow, therefore, should have the effect of alleviating some of that pressure and, in turn, preventing strains on exports that a higher won would occasion (and which would risk throwing the balance of trade figures back into the red).

Balance of trade figures for Korea for years 1980 to the present show that Korea's balance of payments moved into positive figures in March 1986, increasing fairly steadily to a 17 year high in December 1988, before descending into the red again in August 1989. After that, the numbers see-sawed above and below the line, sometimes dramatically before a rapid descent from December 1995 to a 17 year lowpoint in January 1997, from when the situation has improved.

Regarding the effect on the exchange rate, the won appreciated by 3.3% against the US dollar during 1996 and the trend continued for the next two years as the trade surplus rose and pressure was brought to bear by the USA for an appreciated won (with an increase of 8.2% in 1987 and 13.7% against the US dollar in 1988). In 1989, however, the won appreciated only slightly against the US dollar as the effect of the won appreciation over the previous two years started to take effect in the fourth quarter of 1988. Accordingly, Korea's trade surplus fell by 43.9% in the first half of 1989 compared to the same period the year before. (ref. Appendix 9 - current account figures & analysis of exchange rate trends)

Whereas these figures do not allow for the conclusion that imposition of capital inflows was an attempt to control exchange rates, they do show that if this was the intention it did not work.

This subject is addressed by Korea Development Institute (*Ref. 'Korea Year 2000', Korea Development Institute, 1989, p41)* which states that the monetary authorities faced new problems in controlling monetary aggregates due to the large swing in the nation's balance of payments position, when a large supply of money arose from the foreign sector. In order to sterilize the excessive money supply from foreign sector, the monetary authorities restricted the inflow of foreign capital while encouraging overseas investment and the prepayment of foreign debt. The authorities also tightened control of bank credit to large enterprises and substantially reduced policy loans for export finance. As these measures had only limited effects in absorbing excess liquidity, the Bank of Korea depended increasingly on the issuance of Monetary Stabilization Bonds to control the money supply.

c. Does the Government regulate the financial sector to force Korean investment in Korean companies, especially investment in projects that are favored by the Government?

This issue must be seen in terms of the three-way relationship between companies, the banks and the government. Put most simplistically:

- the companies are reliant on the banks for loan funds, loan forgiveness etc. and on the government for creating the right 'environment' for release of those funds (either directly or indirectly)
- the banks are reliant on the government for policy direction (and the history of Korean lending policy seems to be one where the banks acted simply as 'piggy-banks' for government/business initiatives where the government and business shared the risks) and to an extent (although lessening as capital markets open) for the actual funds to lend
- the government is 'reliant' on the companies to realize industrial development (like the X-5 and XC-5 programs) and the banks to channel the funds accordingly and to maintain credit lines to 'prop up' the companies in the interests of that development and the government's reputation domestically and overseas

The recent history of this tripartite relationship contains some shining examples of the way that corruption has played a decisive role in company and project funding and the degree to which corruptly funded 'influence peddling' can not be ignored. But the balance of responsibility for 'forcing' investment can not, in Kroll's opinion, be placed solely on the government. As has been seen recently, the companies themselves appear to be the parties putting up the money necessary to facilitate funding decisions - what complicates this issue is the existence of development policies which, when looked at from the point of view of government volition, tend to suggest that the government is forcing investment upon the companies for favored projects. What further complicates the issue is that many of the recent financing issues where this relationship is played out concern protection from bankruptcy rather than expansion through project development and this raises a whole different set of issues relating to the government's role in protecting the Korean economy as a whole.

On the question of the government's 'forcing' investment by Koreans in Korean companies, the history of Korea's securities industry shows that, up to the early 1980s, the government did indeed force public offerings by companies and created favorable conditions to investors to encourage public participation. The following is a brief account:

Following two market crashes in 1958 and 1959, the government is said to have recognized that the securities market is important in mobilizing domestic capital for the development of the national economy and passed a new Asset Revaluation Act. This resulted in improved dividend policies, tax reforms to stimulate demand for equity securities (since corporations were permitted to revalue book assets to reflect the appreciation in nominal values due to sustained inflation), and the encouragement of corporations to issue new stocks through the conversion of any revaluation surplus.

Importantly also, the government forced corporations wholly or partly-owned by the government to declare attractive dividends. As an example, commercial banks declared dividends in 1961 of between 8% and 12% and the Korea Electric Corporation declared its first dividends of 10%. In addition, the government-owned corporations were ordered to sell stocks through a quotation on the exchange.

In 1968, the Capital Markets Promotion Act, whose stated purpose was to promote the capital market by creating an investment climate which encouraged corporations to distribute their shares widely among the public, included measures where (1) shareholders of listed companies were guaranteed to receive annual dividends at a level equal to the interest rate on one-year time deposits (2) listed companies securities were allowed to be used instead of cash for the payment of guaranteed money of bonding requirements in transactions with the government or government-controlled enterprises (3) the MoFE was given power to sell government-held shares without limitation as to volume and price (4) employees of corporations issuing new shares to the public were allowed to subscribe up to 10% of the new issue (5) personal tax exemptions were provided for the shareholders of listed firms (6) special rates for calculating corporate income taxes and depreciation for the purpose of tax deductions were introduced for listed companies, and others.

The act also established the Korea Investment Corporation (KIC) as a government-owned corporation to facilitate the issuance, distribution and underwriting of securities and to stabilize securities prices. The KIC was abolished in 1977.

A survey conducted in 1970 indicated that, despite incentives to do so, Korean companies were reluctant to go public. According to the survey, most felt that they could not declare annual dividends at the level required (equal to interest rate on one-year time deposits - at that time 23%); they were uncertain whether the securities could be successfully distributed; they feared loss of management control to public shareholders; and there was a lack of investment institutions willing and able to underwrite new issues. An Emergency Decree in 1970 attempted to eliminate the curb money market by requiring that all debts and credits of business enterprises created outside the organized financial market be reported to the government and repayment of such debts was regulated at a fixed interest of 35% per month. This measure, with the Going Public Encouragement Act which was introduced at the same time, gave the MoFE power to force companies to go public.

In 1974, the government issued special instructions requiring public companies to have at least 30% of the total number of shares outstanding in public circulation and encouraged controlling shareholders to lower their holdings from 51% to 30%.

Through these measures, and the establishment of institutions like the Association of Underwriting Companies, the Korea Securities Investment Corporation, the Korea Investment Trust Company, Korea Merchant Banking Corporation, Daehan Investment Trust Company, and others, the government created a boom in public offerings.

Since 1981, the main policy aims that appear to have been attempted concern internationalization of the securities market - allowing foreign portfolio investment in Korea's securities markets and, simultaneously, permitting Korean companies to gain access to the international capital markets, including listing their equity on foreign stock exchanges. (ref. Appendix 10).

Kroll's view of this brief history is that, whereas forcing Korean investment, and forcing companies to open up for investment, were central to the development of the securities industry in Korea up to the 1980s, the various measures taken since then appear to be illustrating the attempt to move away from domestic issues as part of the internationalization of the securities industry. The chronological review of market development which is included in appendix 10 illustrates this well with the number of developments involving 'foreign' issues tending to predominate from the 1980s.

## B. AVAILABILITY AND COST OF CAPITAL FOR AUTO EXPANSION

### 1. The Source of Capital for Auto Expansion

**a. Where is the capital for Korean auto sector expansion coming from?**

**a1. Korea Development Bank - Survey of Facility Investment Plan, May 1997.**

The Survey Of Facility Investment Plan examines the overall trend of facility investments of 2,321 Korean companies. This data is considered to show, through an analysis of facility investments by export ratio, by investment sources, by reasons for investment, by paid-in capital, asset type and through identification of 'bottlenecks' the overall trends of facility investments of principal private sector enterprises. The stated aim of the survey is to provide data necessary for government's policy-making on financing facility investments and for KDB's own financing policies.

At the same time, Kroll considers that this data provides a 'window' through which to view the current policies themselves, as it is manifest that enterprises' facility investment decisions are not a 'one-way street' and that the government's industrial policies are seen at work in these figures.

Facility investment is defined as investments in tangible fixed assets for the operation of the business (ie. land, land development, buildings, structures, equipment). Intangible fixed assets such as patents, goodwill, copyrights are trademarks are excluded.

The figures for the automotive industry disclose a number of important elements in the financing of the auto industry (ref. Appendix 11):

<u>What Is Being Financed?</u>

* Facility investments for the purposes of expansion in production capacity remains the most significant element of financing for auto manufacturers. Although rates have dropped by 3% since the previous year, this represents the majority share at 66% of the total investment forecasted for 1997, (29.253 billion won of a total of 44.5 billion).

* Of the 29.253 billion won, 75% (21,840 billion won) is scheduled to be spent on new projects, the remaining 25% to be spent on expanding existing facilities. This represents a rate of change for 1997 of only 6.7% over the previous year, in which the rate of change was 99%. In other words, the KDB expects a much slower rate on investment in new projects in the auto industry in 1997.

Note: The KDB commented on the low overall increase in facility investment industry-wide and largely attributes this to a contraction in business cycles, a general mistrust in the economic environment due to issues concerning the labor law and insolvency in the wake of Hanbo Steel and Sammi Steel. While the Manufacturing industry as a whole is forecasted to have a negative growth rate of 1.3%, the level of investment in the auto sector is expected to increase by approximately 9%.

* Funding for R&D is expected to see an increase of 42.7% over the previous year, at 7.445 billion won. This is consistent with the added emphasis placed by the government on new technologies and technological self-sufficiency.

<u>How Is It Being Financed?</u>

* Total facility investments for 1997 are estimated at 44.428 billion won, or which 36.123 billion won is expected to come from external financing (or 81.3%). This is divided between stocks; bonds payable; borrowings from local banks in won and in foreign currencies; foreign capital from joint ventures, commercial loans and 'other'; leasing; and 'other external financing'.

* Bonds payable represent the largest single source of expected financing at 16.223 billion won (45% of external financing and 36.5% of all facility investment financing)

* Borrowings from domestic banks is expected to be 11.875 billion won (33% of external financing and 27% of all facility investment financing)

* Of bank borrowings, 7.246 trillion won is expected to be in Korean won, and 4.629 billion won in foreign currency (61% and 39% respectively of bank borrowing)

* Foreign capital is estimated at 2.096 billion won (6% of external financing and 5% of all facility investment financing)

* KDB's estimates that leasing and 'other' will each account for more financing for facility investment than foreign capital. Nevertheless, the rate of change in foreign capital is expected to be 535% over the previous year.

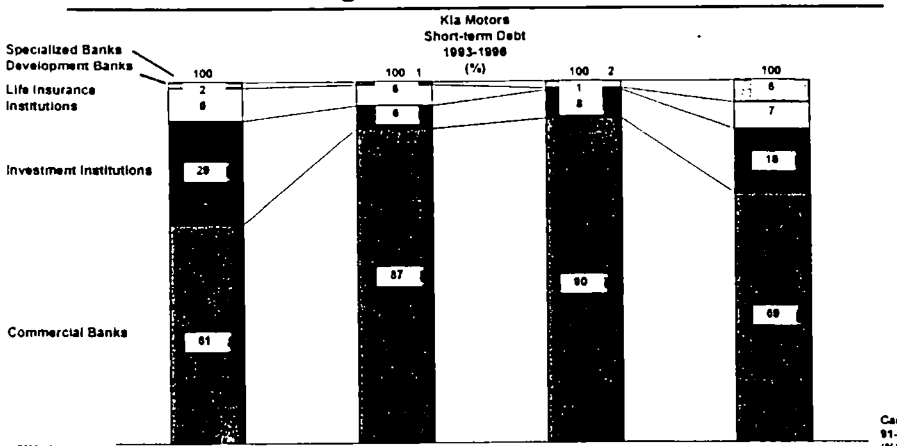
* Internal financing is estimated at 8.305 billion won (19% of total investment) for 1997. This represents an increase of 9% over the previous year's actual figures. KDB's analysis is that dependence on internal financing will continue to be low mainly due to decreasing profitability as a result of stagnant economic forecasts and retreating export prices.

* Stocks (which Kroll interprets to mean sale of shares in auto companies) are expected to contribute 1.1% of the total facility investment in the auto sector in 1997, and represents a decrease of 4.2% over the previous year.

These figures show a number of interesting things about the KDB's and, it could be said, the government's analysis for facility investments in the auto industry for 1997. One of the key issues is the expectation that domestic bank borrowings are expected to account for a third of external financing in 1997. The extent, therefore, to which the government controls the financial system, and has a direct hand in bank lending, is clearly still highly relevant to the auto sector.

## a2. Case Study - Kia Motors

### From '93-95, Kia's Commercial Bank Short-term Borrowings Rose By A CAGR Of 19% As Phase Two Interest Rate Deregulations Were Implemented




| (W bn) | 1993 | 1994 | 1995 | 1996 | Cagr 91-96 (%) |
|---|---|---|---|---|---|
| Commercial Banks | 690.0 | 914.7 | 970.5 | 753.3 | 3.0 |
| Investment Institutions | 327.3 | 67.3 | 85.0 | 196.0 | (15.7) |
| Life Insurance Inst. | 105.2 | 59.3 | 6.1 | 79.5 | (8.9) |
| Development Banks | 17.8 | 9.9 | 20.9 | 68.0 | 58.3 |
| Specialized Banks | - | 0.048 | 0.037 | 0.002 | - |
| Total | 1,140.3 | 1,051.2 | 1,082.5 | 1,096.8 | |

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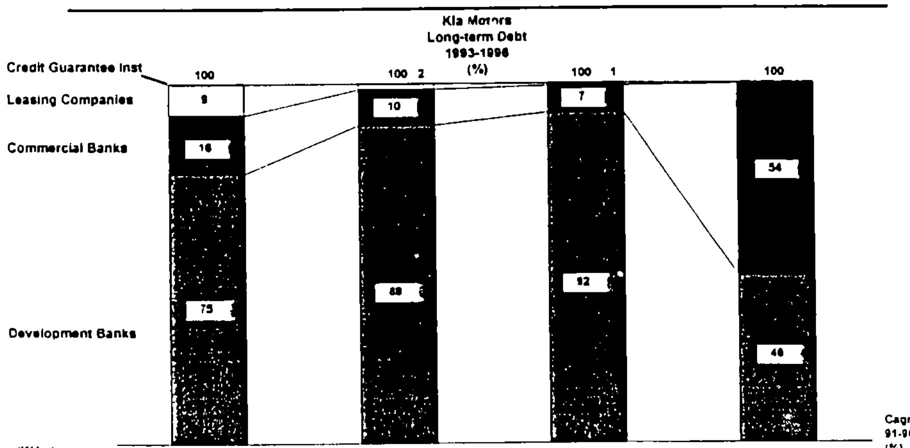
### Development Banks Provided Kia With A Majority Share Of Long Term Borrowings Until 1996 When The Korean Bond Market Was Further Liberalized




| (W bn) | 1993 | 1994 | 1995 | 1996 | Cagr 91-96 (%) |
|---|---|---|---|---|---|
| Development Banks | 176.9 | 254.6 | 272.9 | 282.3 | 14.0 |
| Commercial Banks | 38.4 | 28.6 | 21.9 | 304.1 | 99.3 |
| Leasing Companies | 20.3 | 4.4 | 1.8 | 0.7 | (67.5) |
| Credit Guarantee Inst | - | - | 0.3 | 0.7 | - |
| Total | 235.6 | 287.6 | 298.6 | 587.1 | 34.0 |

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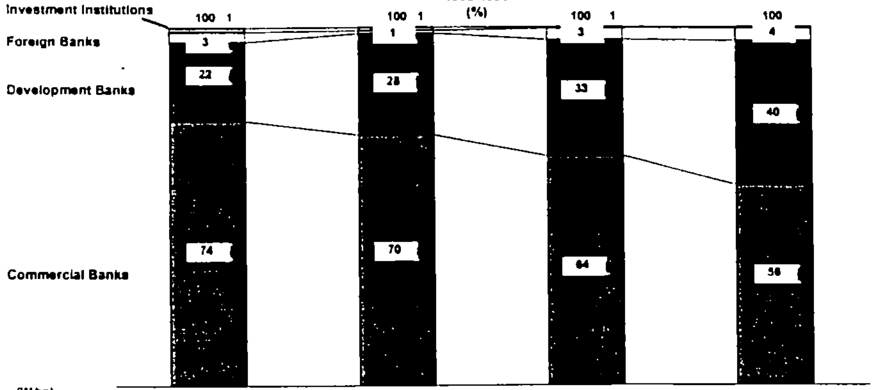
## As Kia's Inability To Repay Debt Became Apparent, Commercial Banks Tightened Credit Policies While Development Banks Stepped In

Kia Motors
Foreign Currency Loans
1993-1996
(%)




| (W bn) | 1993 | 1994 | 1995 | 1996 | Cagr 91-96 (%) |
|---|---|---|---|---|---|
| Commercial Banks | 399.6 | 389.5 | 312.9 | 238.7 | (16.0) |
| Development Banks | 119.2 | 157.4 | 159.7 | 171.3 | 12.9 |
| Foreign Banks | 15.5 | 5.0 | 15.8 | 15.2 | (0.5) |
| Investment Institutions | 6.1 | 4.4 | 1.7 | 1.4 | (38.0) |
| Total | 540.4 | 556.2 | 489.9 | 424.6 | (7.7) |

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## 2. Interest Rates

a. What are the interest rates paid by auto sector companies on their long-term and short-term loans?

This question can be answered on a case by case basis from information which is currently available with additional information of a more general nature provided by analysts on the basis of their general knowledge.

Analysts suggest that Investment Policy Loans given by the Korean Development Bank carry interest rates of 7% - 8%, compared to commercial loans of 11% - 12%. (ref. Vince Kim, Jardine Fleming Securities; Richard Pyo, CS First Boston). Kroll has not sighted corroborating information from KDB on this subject.

It seems apparent that Korean auto makers have also been able to borrow on the international capital markets at interest rates normally unavailable to unprofitable companies because their credit worthiness is bolstered by the government's implicit guarantee and the balance sheets of healthy group members. For example, a very favorable rate was extended recently to Hyundai Motor by Indosuez Bank Hong Kong of LIBOR + 0.55% for a five-year loan of US$60 million. (Note: This loan was declared by Hyundai as being earmarked for overseas expansion). Kroll's impression of this loan is that various elements other than the out-and-out performance of Hyundai Motor must have been brought to bear, and the strength of the group as a whole could well have been one of those elements. Equally, however, the risk may be weighed against the likely outcome for Hyundai of the current 'auto-war' in Korea, where few doubt that Hyundai will come not out on top in a 'consolidated auto industry'.

Perhaps providing some support for the notion that interest rates to auto companies are 'flavored' by other group members, an article about Daewoo's issue of Overseas CBs for overseas expansion discusses Daewoo's precarious reputation with Korean banks. It states that the banks tend to lend Daewoo less and charge it higher interest rates than they do with other chaebol. Apparently, this is because Daewoo has no obvious 'cash cow' (ie. group member generating interest paying cash flow). Clearly, the implication is that other auto companies attract favorable treatment because of group members' financial viability. (ref. "Daewoo

Heavy to issue Overseas CBs for Foreign-Based Auto Plan" Korea Economic Daily July 10 1997).

Several references have been made for 'alternative loans' in the form of an equity investment in an auto company with a 'buy-back' agreement after a fixed time at a fixed premium as a way to raise loan funds at better-than-normal rates. Specific reference was made to Samsung having received funds from a foreign company, Pan Pacific Investments, based in Ireland. PPI apparently bought a major interest in Samsung common stock and an agreement was made after a certain number of years for Samsung to buy back the stock at a premium. With the information available to date, however, it is neither possible to confirm the buy-back agreement nor its details.

From Kroll's research the following is a summary of general interest rates:

* Foreign currency loans = LIBOR + 1 or 2% but this is capped by the Ministry of Finance.

* Commercial paper (maturity date 30-270 days). Rates are 12% from local banks.

* Offshore borrowings require the permission of the Ministry of Finance. These carry interest rates of LIBOR + 1 or 2%.

* Foreign currency loans from commercial banks carry the same rates as offshore borrowings.

* The KDB offers 8-9% for facility investment loans (note: although some have said the lower end is 7%)

* Corporate bonds rates range from 11.5-12%.

* Long term rates (2 yr. corporate bond 11.67%) vs. medium to short term rates (1 yr. debenture at 12%)

Non-Bank Funds Interest Rates

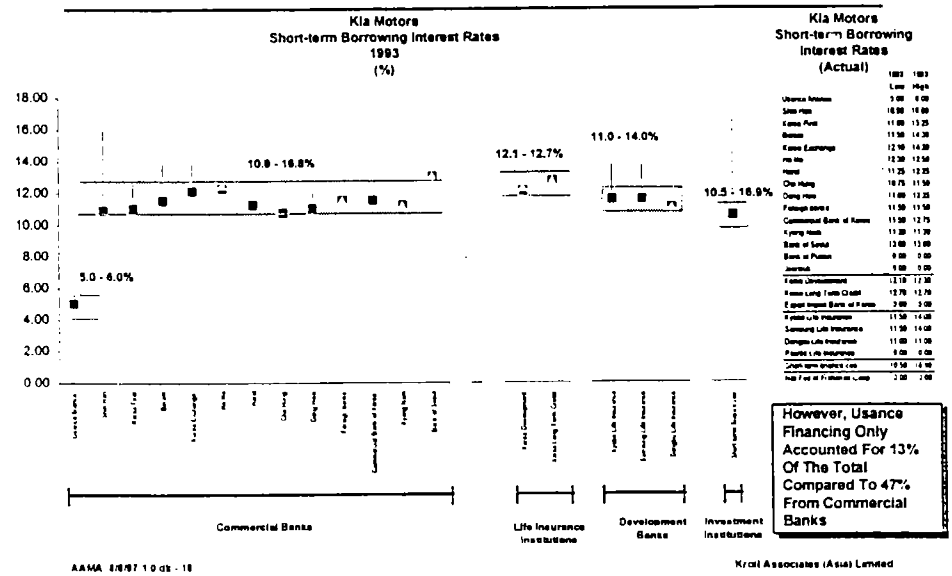
* 1996 Industrial Technology Fund - Aid Plan. At end 1995, the MTIE consolidated and reorganized all the funds related to technology (Industrial-based Technology Development Fund, Industrial Technology Environment Fund, Manufacturing of Trial Goods Fund, High-Tech Development Fund) and consolidated them in the name of Industrial Technology Fund. The new fund's total amount was 524.2 billion won.

Interest rates on loans is set at 7% annually for 8 years. Loan amounts up to 80% of total expenditure under the approved project. Limits vary between projects from 1-3 billion won per project. (ref. KAICA Journal, March 1996).

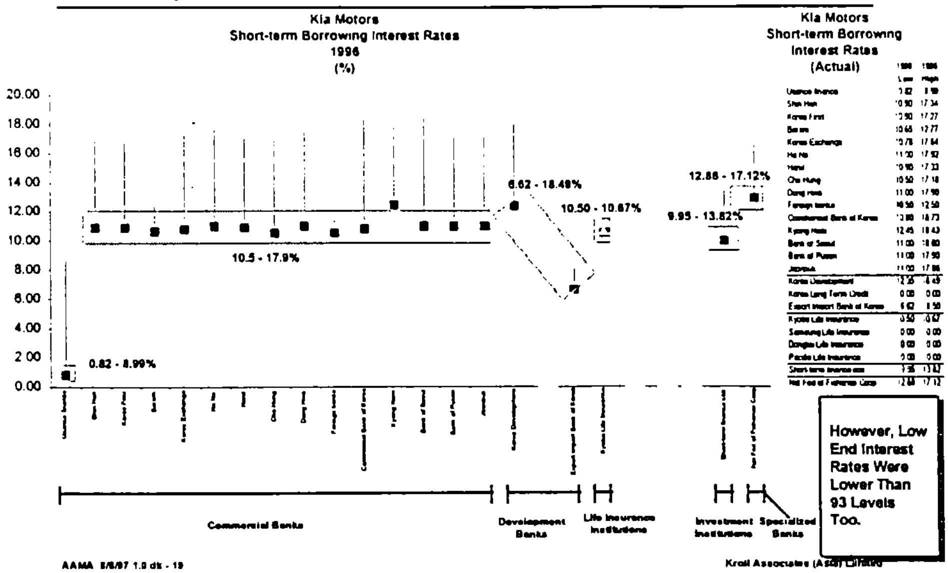
This Fund is clearly not limited to the auto sector and, at present, Kroll does not have sufficient information to offer comment on the amount of funding auto sector companies have received through this mechanism.

## a1. Kia Case Study Continued

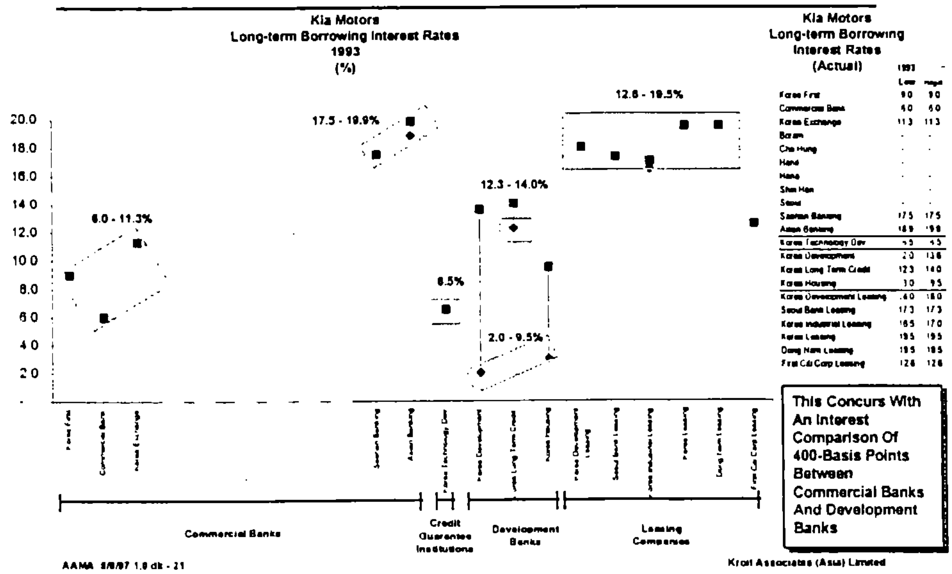
**While Interest Rates Bands Were Generally Higher Among Commercial Banks, Usance Financing Constituted The Lowest Rates At 5 To 6%**



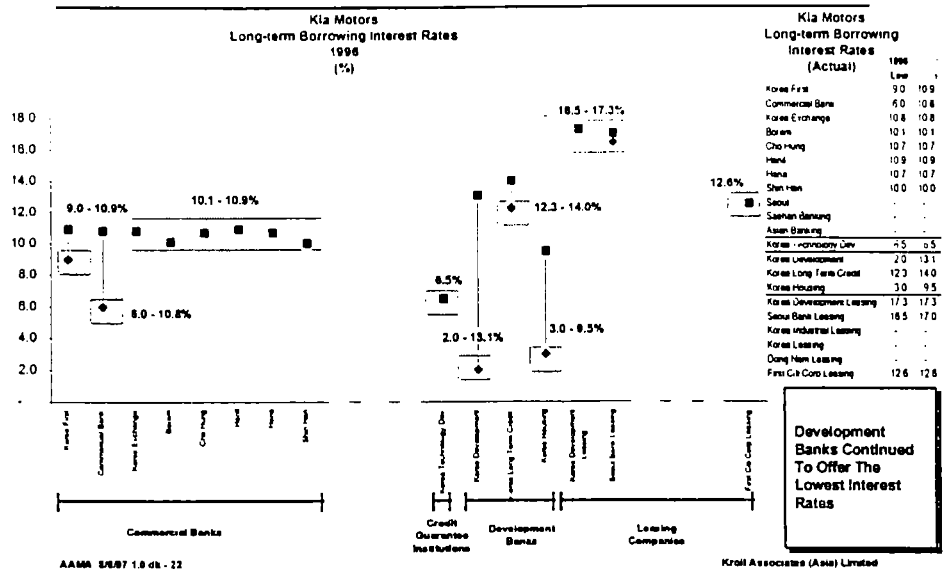
## In 1996, Interest Rates Bands To Kia Were Significantly Wider Than '93 Levels, Indicating Tighter Lending Measures




## Development Banks Provided Kia With A Majority Share Of Long Term Borrowings At Low Interest Rates



In 1996, The Number Of Commercial Banks Issuing Loans To Kia More Than Doubled




### 3. Degree of Preferentiality in Access to Capital

a. To what extent are auto sector companies given preferential access to Korea currency loans?

b. To what extent are auto companies given preferential access to foreign currency loans?

c. Are Korean auto sector companies given regulatory approval for financing that is denied other industries?

At this stage in Kroll's research, there have been no indications that auto sector companies have been singled out for any particular regulatory approvals in relation to expansion financing. Clearly, should this be the case it would be a categorical confirmation that auto companies have received preferential treatment and, as such, Kroll considers this to be an important issue to address in the ensuing phase of the assignment.

**d. Has a disproportionate share of bank loans gone to the auto sector?**

Bulletins published by the Bank of Korea provide running figures on, inter alia, loans and discounts of banks to industry. The classifications used are 'Deposit Money Banks' (Commercial and Specialized Banks) and 'Other Financial Institutions' (including Development Banks, Investment Institutions, Savings Institutions etc). (ref. Appendix 12)

The relevant industry classification for autos is 'Motor Vehicles, Trailers and Semi-Trailers'. (Note: There is no separate classification for the automotive parts industry and it is not know whether this is included under the motor vehicles classification).

Deposit Money Banks

Current figures (as at March 1997) indicate that, for loans from Deposit Money Banks, Motor Vehicles, Trailers and Semi-Trailers stand at 7.842.5 trillion won (including equipment funds). This is slightly more than loans to the Chemical and Chemical Products industry (7.346.7 trillion won) and slightly less than the Machinery and Equipment industry (9.436 trillion won). Greatly exceeding these figures, however, is the Manufacturing sector (87.292 trillion won) and Agriculture, Hunting and Forestry (26.9 trillion won).

* NOTE: Kroll is attempting to determine whether or not the figures for manufacturing are composite figures for industries, like Motor Vehicles, Electrical Machinery etc - and which would thus explain the enormous figures for manufacturing. In that case, the percentage of Motor Vehicle loans could be measured against Total Manufacturing Loans for an assesment of disproportionality.

On the face of it Kroll would conclude that the auto sector has not received a disproportionate share of loans from Deposit Money Banks. Regarding the percentage of funds from the Specialized Banks, which would indicate more clearly the government's direct 'contribution' to these sectors, however, the overall figures would be distorted by the fact that most of the Specialized Banks have specific purposes which lie outside the auto industry. To gain a clearer picture of Specialized Banks' loans to the auto sector, Kroll considers that the loan figures, by industry, for the Industrial Bank of Korea, may provide some illumination. At the time of reporting, however, these figures have not been obtained. Kroll anticipates collecting more information on this issue in the ensuing phase of the assignment.

Other Financial Institutions

Current figures (as at February 1997) indicate that by far the largest share of loans from Other Financial Institutions goes to the Manufacturing sector (102 trillion won). Next, although distantly so, is the Construction sector (26 trillion won). The next highest figures are for the Trade & Repair sector (21 trillion won), then Financial Intermediation (20.75 trillion won). The Motor Vehicles et al. sector has figures of 14.75 trillion won, being slightly more than the Chemical sector (12.6 trillion won).

Note: Comments made in relation to Manufacturing figures above are also relevant here.

The figures for other sectors are all well under those for Motors (eg. Electricity, Gas and Water Supply - 6.2 trillion won; Radio, TV and Communication Equipment - 8.2 trillion won; Basic Metals - 8.8 trillion won; Machinery and Equipment - 8.7 trillion won).

Once again Kroll would not tend to conclude that the auto sector has received a disproportionate share of loans from Other Financial Institutions. As these figures cover a very large number of institutions, however, Kroll feels that a study of the relative lending amounts to the auto industry by the Korea Development Bank would provide another useful tool in assessing disproportion. This study has not been conducted at the time of reporting and Kroll anticipates doing so in the ensuing phase of the assignment.

Kroll suggests that an avenue for comparative analysis is to review production indices for Korea's principal industrial products and their relative contribution to total industrial production and measure this against the relative share of loans from Korean banking institutions. By this method a tentative determination could be made as to whether or not a disproportionate amount of loans are extended to the auto industry.

### 4. Degree of Preferentiality in the Cost of Capital

a. Do loans to the auto sector, whether long-term or short-term, carry interest rates that are lower than interest rates to other sectors?

At least a partial answer to this question will come from a comparison of short and long-term loans in other sectors. Such comparison has not yet been conducted but Kroll's impression is that this will be a straightforward exercise with relevant data being derived from financial statements of a range of Korean industrial sector companies.

Kroll anticipates conducting this comparison in the ensuing phase of the assignment.

**b. Are other financing costs (eg. compensating balances) less for auto sector companies than others?**

Likewise with other financing costs, comparison between business sectors has not yet been made but, at the time of reporting, Kroll has no information about compensating balances which make analysis worthwhile. As this is a possible avenue for preferentiality, however, we anticipate further research on this issue in the ensuing phase of the assignment.

## C. EXTENT OF DEVIATION FROM MARKET ECONOMICS

### 1. Economics of Korean Auto Sector Expansion

a. Do the operating results of Korean auto sector companies justify the investment in capacity expansion?

In Kroll's view, the simple answer to this question is a categorical no. This is not, however, a simple question as it must in general be viewed against the maxim that Korean companies do not expand their businesses on the basis of profits and past performance. In this vein, the question could be viewed (as has been the case with several interviewees) as pre-supposing a 'U.S. slant' on the way businesses should be managed.

One factor which clearly influences the decision to expand capacity in the face of poor returns, leaving aside the general environment where returns are not considered, is the Korean's analysis of economies of scale required in the auto industry. By this analysis, a capacity of one million units per year is the yardstick so that, regardless of current company performance, to be in the auto industry at the turn of the century means, ipso facto, that a company has a capacity of one million units or more per year. The fact that operating results do not, as yet, justify expansion could be analyzed accordingly as an indication that adequate capacity expansion, and commensurate sales profits world-wide, has not yet been reached, thus justifying further expansion.

In Credit Suisse's analysis, the growth in expansion over the last fifteen years has been aimed at achieving economies of scale as Korea's auto production capacity has expanded threefold from 1.47 million units in 1986 to 4.32 million units in 1996. Credit Suisse, in fact, refer to a 'common belief' that economies of scale are only achieved with an output of 2 million units per year. (ref. 'Korean Auto Industry - Downshifting to a lower gear', Credit Suisse First Boston, April 28 1997).

Clearly, Korean auto makers are concerned about operating costs and the effects on company profits. This is exemplified by various cost reduction measures being pursued in the auto industry - Hyundai's "Plus Ten Minus Ten' scheme, Kia's 'P 333' scheme and Daewoo's 'New Automotive Industry Concept - II' being examples. Nevertheless, in part because of the above-mentioned reasons, this has no apparent effect on expansion plans and, indeed, most discussion of cost-cutting revolves around concerns over price-competitiveness.

b. What has been the return on sales by Korean auto companies?

The Samsung Report contains the following chart:

<Changes in domestic auto makers' sales profit rates>

| | 1994 | 1995 | 1996 |
|---|---|---|---|
| Hyundai Motors | 1.5% | 1.5% | 0.7% |
| Kia Motors | -1.5% | 0.2% | 0.4% |
| Daewoo Motors | -0.3% | 0.3% | 0.7% |
| Ssangyong Motors | -9.8% | -12.7% | -12.5% |

*Note : Sales profit = (net profit / sales turnover) x100

This compares with the report's analysis of liability rates for the same companies:

< Changes in domestic auto makers' liabilities rate>

| | 1994 | 1995 | 1996 |
|---|---|---|---|
| Hyundai Motors | 335.8% | 349.7% | 383.3% |
| Kia Motors | 447.0% | 378.1% | 379.7% |
| Daewoo Motors | 594.5% | 744.6% | 744.5% |
| Ssangyong Motors | 962.3% | 1,024.4% | 1,693.7% |

According to a model where sales profits would justify increasing debt levels:

- Kia has followed an acceptable trend of debt to sales profits (as Kia's debt-to-equity decreases whilst sales profits increase)
- Daewoo is following a parallel path of increasing both ( as Daewoo's debt-to-equity has increased as has its profits)
- Hyundai and Ssangyong demonstrably fail to follow it (Hyundai's debt-to-equity has increased slightly, while profits have decreased, and Ssangyong's debt-to-equity has increased and profits have continued to fall).

c. What has been the return on assets of the major Korean auto companies?

At the time of reporting, this analysis has not been conducted

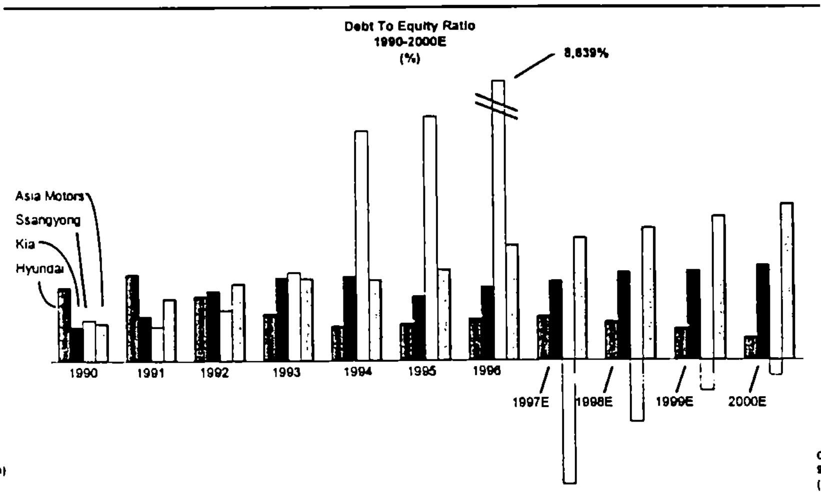
d. What has been the return on equity of the major Korea auto companies?

At the time of reporting, this analysis has not been conducted.

e. Debt-to-Equity Analysis

Clearly, the debt-to-equity ratio of operating companies indicate that capacity expansion financing is not made on the basis of financial performance.

## Debt To Equity Ratio Of Major Korean Automakers




| (W bn) | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997E | 1998E | 1999E | 2000E | Cagr 91-96 (%) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Hyundai | 236.5 | 278.5 | 206.8 | 151.4 | 111.4 | 118.3 | 133.6 | 141.7 | 123.4 | 99.1 | 71.4 | (9.1) |
| Kia | 109.7 | 144.6 | 223.5 | 266.2 | 272.1 | 206.9 | 236.1 | 253.9 | 282.9 | 286.0 | 303.0 | 13.6 |
| Ssangyong | 131.7 | 110.3 | 163.5 | 283.8 | 740.0 | 786.9 | 8,639.4 | (1,843.6) | (892.3) | (829.2) | (510.0) | 100.8 |
| Asia Motors | 119.9 | 200.2 | 248.6 | 284.7 | 280 0 | 292.3 | 389.9 | 393.0 | 425.4 | 461.7 | 501.4 | 20.6 |

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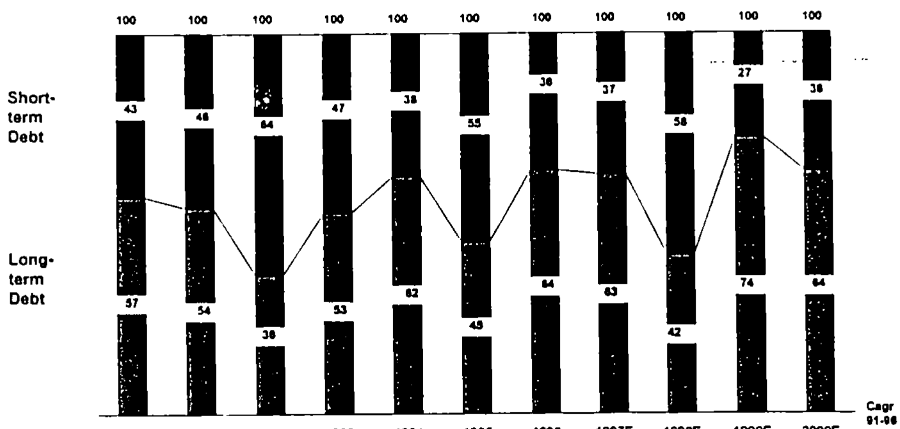
## Debt Breakdown of Hyundai Motors




| (W bn) | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997E | 1998E | 1999E | 2000E | Cagr 91-96 (%) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Long-term Debt | 1,270.9 | 1,490.1 | 887.6 | 1,218.7 | 1,220.7 | 1,107.8 | 1,894.7 | 1,940.9 | 1,198.2 | 2,272.2 | 1,737.5 | 8.9 |
| Short-term Debt | 984.2 | 1,270.8 | 1,557.8 | 1,095.9 | 739.8 | 1,355.5 | 1,067.1 | 1,153.0 | 1,692.5 | 862.3 | 988.9 | 1.7 |

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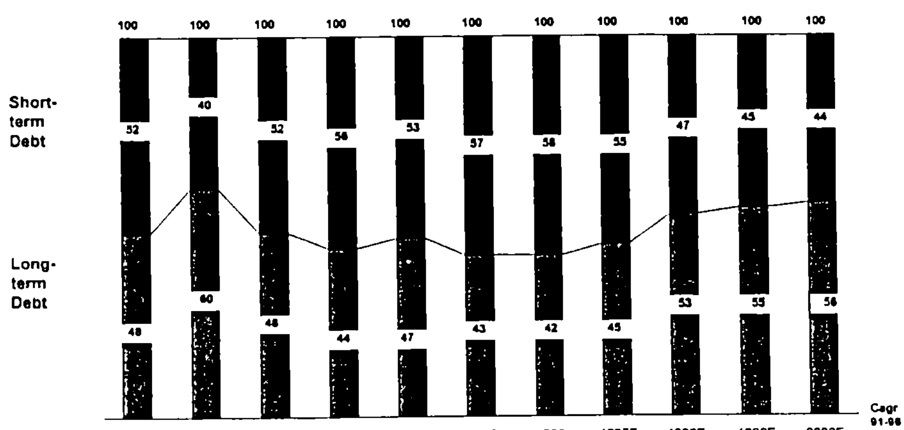
## Debt Breakdown Of Kia Motors




| (W bn) | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997E | 1998E | 1999E | 2000E | Cagr 91-96 (%) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Long-term Debt | 488.2 | 900.2 | 1,018.5 | 1,186.4 | 1,345.0 | 1,284.0 | 1,418.0 | 1,607.1 | 2,118.3 | 2,279.0 | 2,477.0 | 19.4 |
| Short-term Debt | 523.0 | 593.5 | 1,084.8 | 1,493.9 | 1,520.9 | 1,731.3 | 1,923.2 | 1,947.3 | 1,868.3 | 1,882.0 | 1,949.5 | 24.2 |

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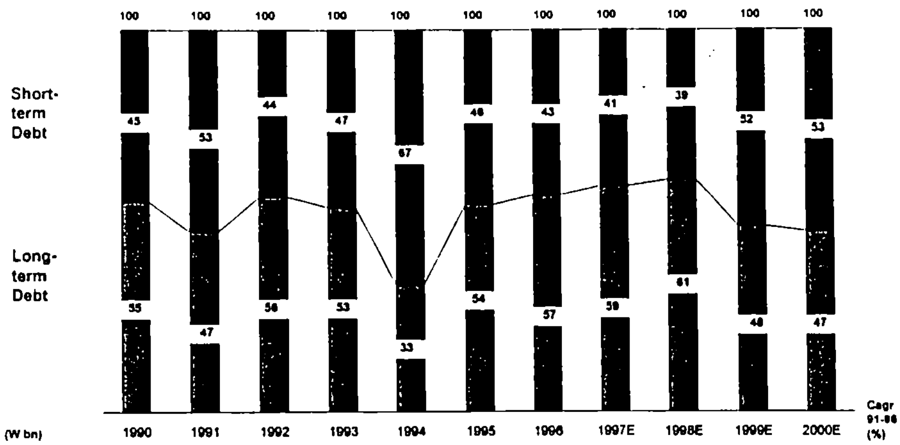
## Debt Breakdown Of Ssangyong Motors




| (W bn) | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997E | 1998E | 1999E | 2000E | Cagr 91-96 (%) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Long-term Debt | 120.0 | 206.0 | 279.0 | 404.0 | 1,087.0 | 981.0 | 1,372.0 | 1,391.0 | 1,508.0 | 2,204.0 | 2,445.0 | 51.8 |
| Short-term Debt | 146.0 | 183.0 | 355.0 | 460.0 | 537.0 | 1,151.0 | 1,785.0 | 2,004.0 | 2,320.0 | 2,073.0 | 2,180.0 | 50.1 |

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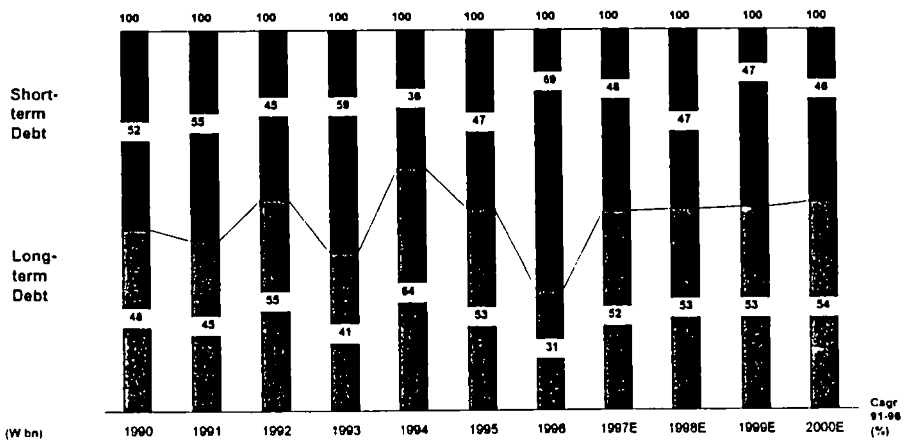
## Debt Breakdown Of Asia Motors




| (W bn) | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997E | 1998E | 1999E | 2000E | Cagr 91-96 (%) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Long-term Debt | 142.5 | 257.6 | 459.8 | 422.0 | 759.1 | 780.0 | 522.5 | 925.6 | 1,022.2 | 1,119.7 | 1,271.4 | 24.2 |
| Short-term Debt | 156.2 | 318.2 | 369.9 | 600.0 | 434.3 | 697.8 | 1,147.5 | 852.3 | 919.6 | 987.5 | 1,089.2 | 39.4 |

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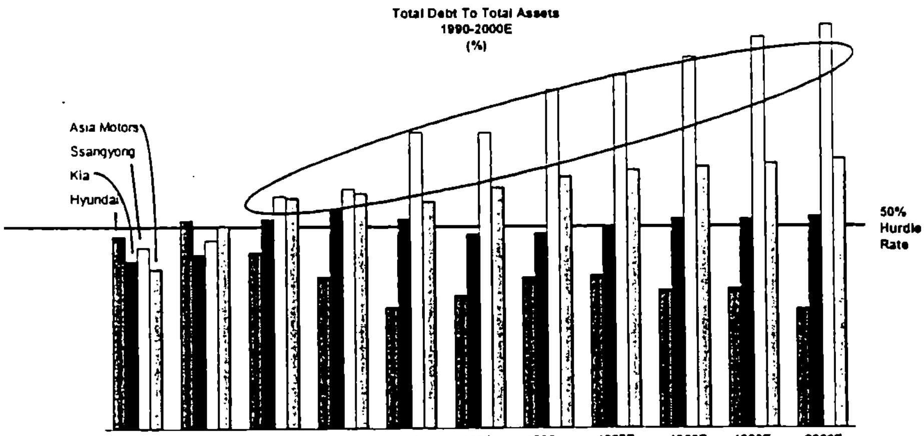
## A Ratio Of Over 50% Raises Concerns That The Assets Of Kia, Ssangyong And Asia Motors Would Be Financed On A Short-term Basis By Creditors




| (%) | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997E | 1998E | 1999E | 2000E | Cagr 91-96 (%) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Hyundai | 47.4 | 51.3 | 43.4 | 37.3 | 29.7 | 32.6 | 37.0 | 37.8 | 33.9 | 34.4 | 29.2 | (4.0) |
| Kia | 41.2 | 42.8 | 51.5 | 53.8 | 51.5 | 47.9 | 48.1 | 49.7 | 51.6 | 51.5 | 52.1 | 2.8 |
| Ssangyong | 44.7 | 46.5 | 57.1 | 59.0 | 73.1 | 73.0 | 83.8 | 87.2 | 92.0 | 96.9 | 99.8 | 11.0 |
| Asia Motors | 39.3 | 50.0 | 56.8 | 57.9 | 55.9 | 59.4 | 62.2 | 63.7 | 64.6 | 65.3 | 66.6 | 7.9 |

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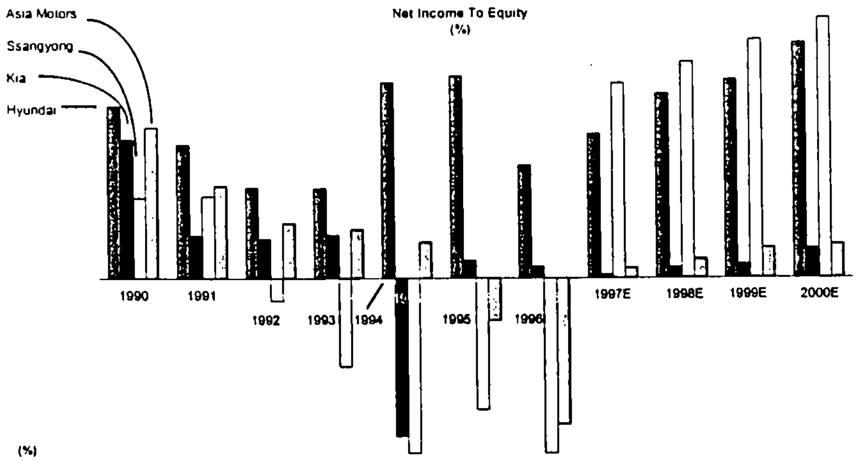
## Net Income To Equity




| (%) | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997E | 1998E | 1999E | 2000E | Cagr 91-96 (%) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Hyundai | 7.9 | 6.1 | 4.2 | 4.1 | 9.0 | 9.3 | 5.2 | 6.6 | 8.5 | 9.1 | 10.6 | (92.9) |
| Kia | 6.4 | 2.0 | 1.8 | 2.0 | (7.2) | 0.8 | 0.5 | 0.2 | 0.5 | 0.6 | 1.3 | (33.9) |
| Ssangyong | 3.7 | 3.8 | (2.9) | (23.1) | (37.9) | (48.7) | (643.9) | 118.9 | 58.7 | 38.4 | 25.4 | - |
| Asia Motors | 7.0 | 4.3 | 2.6 | 2.2 | 1.6 | (1.9) | (6.7) | 0.5 | 0.9 | 1.4 | 1.5 | - |

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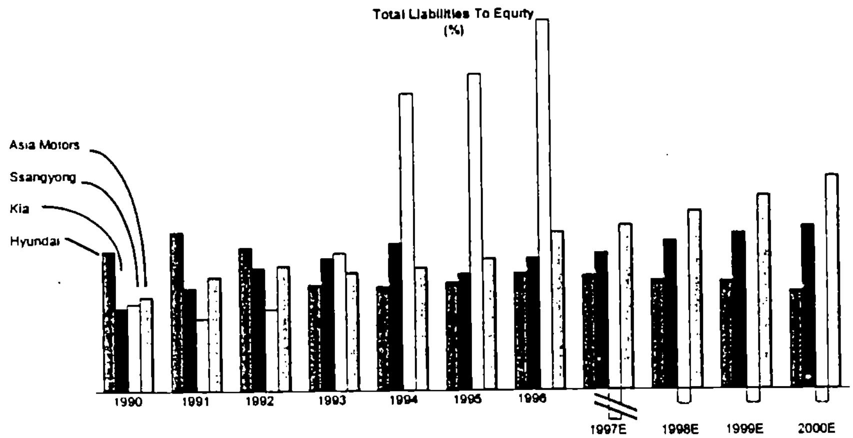
## Total Liabilities To Equity




| (%) | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997E | 1998E | 1999E | 2000E | Caur 91-96 (%) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Hyundai | 453.4 | 516.0 | 463.5 | 341.5 | 335.8 | 349.7 | 379.2 | 370.0 | 353.6 | 349.6 | 317.3 | (2.9) |
| Kia | 269.2 | 332.0 | 396.7 | 429.3 | 477.1 | 378.1 | 427.1 | 442.2 | 482.3 | 505.6 | 528.2 | 8.0 |
| Ssangyong | 282.2 | 235.4 | 264.9 | 445.1 | 962.4 | 1,024.7 | 10,511.3 | (2,221.4) | (1,081.9) | (783.1) | (618.9) | (100.0) |
| Asia Motors | 304.5 | 369.2 | 403.7 | 382.5 | 397.3 | 425.5 | 512.1 | 533.5 | 578.0 | 626.5 | 691.5 | 9.1 |

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## 2. Market-Driven Cost of Capital

a. If the Korean Government allowed entirely market-driven decisions on capital allocations, would Korean auto sector companies have the same access to capital to finance their capacity expansion, at the same interest rates?

Kroll's impression on the subject of interest rate preferentiality is, at this stage, that there is no discernible such preference given. Loans of LIBOR + 1% are the apparent norm in dealing with offshore financing which, aside from the 'comfort' of group overall performance and suggestion of government 'endorsement', are considered to be the most market-driven of all auto financing. These decisions are made by overseas lenders presumably with full knowledge of the saturation of the auto market in Korea, of the bottom-line performance of the companies etc. yet they are still lending.

Loans from commercial banks appear to be carrying 'standard' interest rates of around 12% and Kroll does not have information leading to the suggestion that the auto sector's rates are reduced by non-market intervention.

Loans for facility investment from KDB carry an interest rate of 7% - 9% and this is low compared to commercial rates. This could be seen as decidedly 'non-market', however, the auto industry is not alone in deriving this apparent interest rate preference.

The increasing extent to which auto companies, and companies in other sectors, are able to raise finance in the international markets means, in Kroll's view, a lessening of the effect of, and dependence on, any preferentiality by the government, except when taking into consideration granted favorable access to other forms of external financing over which the government has direct, and recently tightened, control. At the time of reporting, however, Kroll has found no indications that auto companies are provided with more favorable treatment in liberalization issues than other Korea companies.

Accordingly, Kroll's view is that the question must be looked at in terms of access to capital as a result government 'sponsorship' is indirectly proportional to the level of financing obtained in the international markets where market-driven costs prevail.

b. What has been the impact of preferential access to capital on the Korean auto sector rate of capacity expansion?

Kroll's view, from the well documented accounts of industrial development in Korea in the last thirty-five years, is that preferential access to capital has been the architectonic of expansion in the auto industry and, indeed, most other 'key' industries in Korea.

The impact of this preference is that the auto companies are overly confident that 'the money will be there'. This has the effect of encouraging expansion without regard for current company performance.

## D. OTHER

**a. Have the major auto producing companies and/or their related chaebol companies given any political or other 'contributions' to ensure favored status?**

Most references to the payment of 'contributions' or bribes by auto-making chaebol center on Samsung and Daewoo. The following is a brief account:

<u>Samsung</u>
References are plentiful to auto-making chaebol being involved in the 'slush-funds' of former Presidents. Samsung, for example, is known to have contributed US$33 million to the slush-fund of former President Roh Tae-woo and, further, that this donation never appeared on any corporate balance sheets. Roh, himself, confessed to having received hundreds of millions of dollars in unreported contributions from Korean companies. Some reports cited a figure of US$650 million in such contributions.

In Samsung's case, government prosecutors are referred to as having included in Lee's indictment the charge that he had bribed former President Roh to secure Samsung's initial truck manufacturing license. This comment was made in the media in relation (and with obvious editorial intent) to the Kim administration's approval for Samsung to enter the auto manufacturing sector (although that article stresses that the latter approval was made in the name of deregulation).

Lee was also accused of pursuing government favor through 'contributions' in getting Samsung Aerospace selected as prime contractor for the South Korean production of 120 F-16 jet fighters under license from Lockheed Martin Corp.

Outside Korea, Samsung has also had exposure for paying 'contributions' to politicians. In February 1996, Samsung America was indicted on a charge of funneling contributions to California Rep. Jay C. Kim. Hyundai Motor America and Korea Air Lines were indicted on the same charge on month earlier. All companies pleaded guilty and paid fines. Samsung channeled money in the name of company employees and refunded the money from company coffers.

Daewoo

Included in the list of contributors was Daewoo's chairman, Kim Woo-choong. Korean Prosecutors demanded jail sentences for Kim and Samsungs Lee Kun-hee.

Kim was also convicted, but received a suspended sentence, in 1993 for paying a bribe in 1990 of US$250,000 to the president of Korea Electric Power Corporation.

The 'contribution' system, however, must be seen both from the perspective of the payers and the payees. One article quoted Park Ung-suh, president of Samsung Petrochemical Co. as saying "Throw stones if you find we are guilty. If we have to take it, we'll take it. But I say this with a very light burden on my conscience. Don't blame our intentions and don't distort the circumstances. The fact is very clear that we are the victims". The picture being presented, and in Kroll's view of this whole episode it is a convincing one, is that Korean corporations accepted the 'fact' that, under former President Roh and his predecessors, heads of large companies who refused to make such 'contributions' risked seeing their businesses ruined. Kroll's attitude to this sort of statement, however, is that one needs to be aware of the tendency to heap all responsibility on the 'sacrificial lamb', and the placards in Seoul referring to former President Roh as the 'Big Bandit' would seem to be an indication of this tendency.

In counterbalance to this notion, however, is the assertion by Korean prosecutors that the chaebol won government favors that enabled them to freeze out competitors and dominate the South Korean economy.

It is difficult to say with any certainty, therefore, that chaebols made 'contributions' for the purpose of ensuring favored status, just as it is difficult to say that the government simply 'extorted' money from chaebol with threats of ruin, although both statements have been made and can probably by supported.

Kroll's opinion on this issue is that attribution of ultimate volition, or the search for the correct causal chain, is to a large extent a futile exercise and conclusive support will not be found, leaving the subject open to speculation. It seems clear, however, that regardless of that analysis, both the companies and the politicians benefited so that the concluding statement can read: the chaebols made contributions and, as a result, were granted favored status. (ref. Appendix 13).

## THE X-5 PROJECT

Kroll has translated a study entitled 'The Auto Industry's Mid/Long-term Development Plan - The Challenges Towards Year 2001', which deals extensively with the X-5 Development Policy, produced by the Automobile Industry Development Association, October, 1992 (possibly KAICA.- Doc. 2 of Korean language material provided as an appendix to Phase 2 report. Ref. Appendix 14).

The Project's aims, summarized in chart form are:

3)X-5 Project's development direction

i)Policy direction by stage

| X-5 stage one ('92 - '94) | X-5 stage two ('95- '97) | X-5 stage three ('98 - 2000) |
|---|---|---|
| **Developing period**<br><br>-Large expansion of production capacity<br><br>-Create export base (put priority on passenger vehicle, diversification)<br><br>-Acquire core technology<br><br>-Develop the auto-parts industry<br><br>-Achieve national understanding | **Leaping period**<br><br>-Improve quality standard<br><br>-Expand export (passenger vehicle -> commercial vehicle)<br><br>-Secure independent technology<br><br>-Expand overseas CKD supply | **Maturing period**<br><br>-Promote internationalization<br><br>-Turn the auto industry into the leading export industry<br><br>-Acquire applied technology<br><br>-Expand overseas transplant |

ii)Goals by stage

Production

| X-5 stage one ('92 -'94) | X-5 stage two ('95 - '97) | X-5 stage three ('98 - 2000) |
|---|---|---|
| (unit: 1,000units)<br>-Capacity: 2,800 | (unit : 1000 units)<br>-Capacity: 3,400 | (unit : 1,000 units)<br>-Capacity: 4,000 |

| | | |
|---|---|---|
| -Production: 1,910<br><br>-Secure financial resources for facility investment<br>-Acquire factory site<br>-Maintain adequate production system | -Production: 2,490<br><br>-Secure internationally competitive production units(volume)<br>-Develop the auto-parts companies to be large in business scale<br>-Establish specialized production system | -Production: 3,200<br><br>-International specialization of production<br>-Expand Transplant<br>-Full-scale internationalization |

Export

| | | |
|---|---|---|
| -Export : 610<br><br>-Acquire high-speed driving test site<br>-Diversify export markets | -Export : 870<br><br>-Expand overseas CKD export<br>-Expand overseas sales network | -Export : 1,200<br><br>-Establish global net work<br>-Reinforce international cooperation |

Technology

| | | |
|---|---|---|
| -Acquire core technology<br>-Acquire original models<br>-Localize core parts<br><br>-Expand technology development investment<br>-Establish research base | -Acquire independent technology<br>-Diversify original models<br>-Develop electric car<br><br>-Set up overseas research centers<br>-Auto-parts technology's overseas aid | -Acquire applied technology<br>-Localize electronic control system<br>-Develop high-tech function car<br><br>-Expand specialized research centers<br>-Export technology |

Others

| | | |
|---|---|---|
| -Acquire technical man power<br>-Settle industrial peace<br>-Develop the auto-parts industry | -Drastically improve productivity<br>-Improve industrial conditions<br>-Cope with changes in the trade environment | -Become the developed auto producing country |

iii) Site demand by stage

| | The first stage ('92 - '94 ) | The second stage ('95 - '97) | The third stage ('98 - 2000) |
|---|---|---|---|
| Factory site | 470 pyung | 650 pyung | 650 pyung |
| Driving test site | 1,540 | 600 | 1,000 |
| Auto-parts industrial complex | 1,500 | 800 | 800 |
| Total | 3,510 pyung | 2,050 pyung | 2,450 pyung |

Note : 1 pyung = 3.954 sq.yds

iv) Funds required by stage

| | The first stage ('92 -'94) | The second stage ('95 -'97) | The third stage ('98 -2000) |
|---|---|---|---|
| Facility investment | 5.7 trillion won | 4.5 trillion won | 6.5 trillion won |
| -internal raising | 1.2 trillion won | 1.7 trillion won | 2.3 trillion won |
| -external raising | 4.5 trillion won | 2.8 trillion won | 4.2 trillion won |
| (required foreign currency) | (US$ 2.5 billion) | (US$ 1.5 billion) | (US$1.3 billion) |
| Technology development investment | 2.5 trillion won | 3.8 trillion won | 5.4 trillion won |
| Ratio to Sales turnover (%) | 5.0 | 5.5 | 6.0 |
| Total | 8.2 trillion won | 8.3 trillion won | 11.9 trillion won |

A section of this document refers to 'aid' from the government to assist in the funding of facility investment, as follows:

a)The government is considering the system reform to aid the auto industry's investment expansion:

-Allow expansion of foreign currency loans and commercial loans, relax conditions for issuing overseas bonds, etc.

-Relax buyer's payment term (only subject to small size passenger car (below 1500cc))

- (existing regulation) down payment 30%, on 12 months installments basis

- (relaxed term) down payment 30%, on 36 months installments basis

v)Increase tax benefits for facility investment

-Shorten the regulated auto manufacturing facilities' life
reform 'The Corporation Tax' regulation. (7 years to 6 years)

At the time of reporting, Kroll has not fully analyzed this document. The information presented here appears to be the most relevant information on expansion financing issues and, even in 1992, clearly avoids making direct reference to government preference on loans. As more documents are translated, Kroll will have the opportunity to conduct more rigorous analysis.

## SUBSIDIARY QUESTIONS

The following questions arose from client review of Kroll's Draft Phase Two Report. They are presented here with reference (in italics) to the relevant quote from the report which gives rise to the question.

### *1. Credit Controls*

*An aspect of the restructuring was a projected credit control reform plan implemented in 1991. This is when the government selected Kia Motors for the exclusion from credit controls and restrictions on real estate investments. The government based its selection upon the fact that Kia's share distribution is better than many other publicly listed companies.*

*("Selected Firms to be Exempt From Credit Controls" Korea Economic Daily March 16 1991- p.19)*

**a. What exactly was involved, how significant was it, and was Kia one of only a few 'favored' companies or were there many?**

This announcement cites Finance Ministry sources reference to a projected 'credit control reform plan'. Kia Motors was cited by the Ministry sources as a leading candidate on the basis of its share distribution, however, the exclusion is made on the basis of a successful application which is scrutinized by 'related government agencies', of which the National Tax Administration, the Office of Bank Supervision and Examination and the Securities Supervisory Board are mentioned specifically.

The article provides no detail on the terms of the exclusion, nor does it refer to any other likely candidates.

In the same year, a further announcement about government policy in relation to credit controls was made: "The government continued its hold over the industries in the early '90's when it informed the 30 chaebol groups to choose 3 industries as its core businesses in return for loosened credit restrictions on the amount of borrowing". *(Ref. "Does Korea Inc. Need a New Boss?" Electronic Business December 1, 1991)*

**b. What was the impact of the Korean government's policy, did it channel funds to chaebol auto operations; if so, to what extent?**

The policy initiative behind this request stemmed from the Korean government's desire to limit the 'spread' of chaebol activity, providing an incentive for them to do so.

The article refers to loosening of restrictions on borrowing limits but not to the issue of channeling of funds. Like many similar articles, government industrial policy is described as controlling labor, direct subsidies and tariff offsets for exporters, import restrictions, control of banks and credit policies, and input on company expansion plans. In the climate around 1991, however, the article refers to growing opposition to the "previously authoritarian approach" and the fact that executives at some chaebol are "eager to be rid of government intervention in determining corporate strategies" but that some observers see difficulties in "moving away from government support and protection", whilst, the article declares, all sectors think the government should continue to be involved in R&D.

There is no mention of funds channeling here or in any other reference cited on policy reforms in 1991. The way this direction is presented, however, is in the context of the government's desire to reduce the scope and influence of the chaebol which had, until then, aided Korea's industrial growth but which, more recently, was creating an inequitable situation which disadvantaged small and medium enterprises.

Concentration on the promotion of small and medium enterprises appears as a strong feature of Korean government's obvious 'intervention' in the economy. To this end, reference is drawn to the XC-5 Policy which cites investment sources for expansion of the parts industry as, in part:

1. Public Listings of auto-parts companies (from 20% in 1997 to 40% in 2000)
2. Government funds - Small and Medium Enterprises Fund; Fund for Local Machinery Producers; Industrial R&D Fund; Industry Development Fund
3. Guarantees from buyers to encourage lending to auto-parts makers

From this it appears consistent that the government's policies for industry expansion do not involve facilitating the growth and continued dominance of the chaebol and that the '3 core businesses' direction is less a 'direction for growth' than a 'direction for limitation' and that, whether or funds have been channeled to auto companies, it was not through this mechanism.

References to follow-up action in respect of this direction are scarce. One reference, however, indicates that the government's control may not have been as effective as it might: "Analysts believe that the government's current policy of forcing the chaebol to specialize its several core industries is likely to be abandoned. But doubts remain about the government's commitment to the new chaebol policy. The administration, for example, still wants to stop Hyundai from entering the steel sector by building a large integrated steel mill".*(Ref. "Samsung Wins Permission to Make Cars: South Korea Alters Policy to Let Chaebol into New Industries" Financial Times London Edition December 8, 1994)*

Another source indicated in 1995 that the government will use low- rate state financing as a lure to have the top ten chaebol groups limit their core industries.

The situation in 1997, at least since July, is that the Ministry of Finance and Economy has prohibited chaebol's from borrowing in excess of 45% of a bank's shareholder capital. The credit limit for each chaebol-affiliated company is 15% of the banks' capital. A Korea Economic Daily report states that, as at July 17 1997, there are 19 chaebol which have borrowings in excess of the 45% limit from 12 banks. To minimize the shock to business groups, the ministry has offered a three-year grace period for compliance.

*(Ref. 'Stricter Loan Ceilings for Conglomerates to be Enforced in August', Korea Economic Daily, 07/17/97)*

### 2. Anti-Bankruptcy Pact

*It was reported in an article published in April 1997 that the top ten banks of South Korea have agreed to support local companies (the anti-bankruptcy pact was not signed until May 1997) which are facing financial difficulties to prevent an increasing number of bankruptcies. The banks* *include Cho Hung Bank, Commercial Bank of Korea, Korea First Bank, Shin Han Bank, Korea Development Bank and Hana Bank. The support includes an evaluation of the financial status of the troubled companies and a series of 'rescue measures' which include lending with lower interest rates, filing court receivership, sales of management rights to third parties and allowance of liquidation procedures. The banks have stated that they will try to bring other non-banking financial institutions on board to support the flagging companies.*

*("Ten Korean Banks Agree on Plan to Aid Troubled Companies"- The Asian Wall Street Journal- April 16 1997)*

**a. What is the story behind the pact; Was the government involved in its formation; if so, who, when, why and to what extent?**

Clearly, preventing a swath of corporate bankruptcies is in the interests of the government, most especially in an election year. One analyst Kroll interviewed declared, for example, his belief that Ssangyong Motor (and possibly the whole group) will fold in 1998, after the election, and that it will be 'propped up' until then by direction of the government.

In the words of one banker: "We decided to take the united action on the view that companies and we, creditor banks, are riding on the same vessel." Clearly, the impression meant to be conveyed here is that the initiative is the banks. One reporter, however believes otherwise: "The government has come up with some solutions. Among them: more intervention. A Bankruptcy Prevention Accord drawn up in May asks financial institutions to help cash-strapped firms by not calling in their loans until a restructuring has been completed. It is supposed to be voluntary, but lenders were told that those who refused to sign up may be the subject of special probes into the way they do business. Complains an executive of a merchant bank: "The objective is to facilitate restructuring without forcing the company to go belly up. But this has distorted the market as the creditors are dictated to by the government".
*('Bankruptcies: Going Under in Korea: Can Seoul Stanch The Corporate Bloodletting?' AsiaWeek By Laxmi Nakarmi Seoul - 06/13/97)*

This is an unequivocal statement indicating that the government was, indeed, involved in the formation of the pact. As the article does not cite any government references, however, it remains unclear as to who, when (other than in May 1997) and exactly why.

The article likens the pack to the system of 'policy loans' through which the Ministry of Finance and the Economy directed funds to nurture the development of the chaebols, which system was formally 'abolished' in 1995, describing the pact as a return to the days when bureaucrats ruled the financial system. The subject of intervention aside, however, a clear distinction should be drawn between policy loans (for development and expansion purposes) and rescue loans (for rescue purposes) although, in Kroll's view, it could be argued that the necessity for rescue loans is a direct result of the excess and, in the words of Milton Kim of Ssangyong Securities, 'misallocated funds' of the policy loan era.

### *Kia's Bankruptcy Protection*

An article concerning Kia's current financial difficulties is important in the light of the question of why exactly administers the anti-bankruptcy system. The following article refers to a clear statement from the Ministry of Finance that it operates such a fund, although the possibility remains that this statement refers to another fund dedicated to small business, rather than to the 'anti-bankruptcy pact' referred to elsewhere: "The Ministry of Finance and Economy promised cheap loans to help cash-strained Kia subcontractors. The loans will come from a special fund created this year to keep small businesses from bankruptcy amid the overall economic slowdown. *(Ref. 'Kia Plans Sell-Offs to Ease Cash Squeeze'. The Wall Street Journal Europe 07/17/97)*

A key question, in the light of the current study is: Is the money being released via the anti-bankruptcy pact being used to fund continued expansion of the effected companies? Presently, there does not appear to be sufficient information available to answer that question - all one can say is that, despite being under bankruptcy protection, Kia Motors' stated investment in expansion will increase to 450 billion won for the next year, up from a reported 150 billion won in the previous year - a subsidiary question, therefore, is how much of this sum is going to be raised through instruments like corporate bonds.

The government has stated publicly that every measure would be taken to ensure that Kia's "near bankruptcy" would not lead to a financial crisis. The Finance and Economy Minister, Kang Kyong-shik, was quoted as saying that his ministry would play "an active role in containing the fallout". In the same statement, however, he declared that "there is no change in our basic policy that we will not directly help private enterprises" but reiterated that "the government will do all it can when there are fears of disorder in the financial market". Clearly, such statements do not add anything tangible to the study of the government's actual role in the operations of the anti-bankruptcy pact and, in Kroll's view, serve only as an indication that the government feels compelled to address the mutually exclusive needs for market forces to prevail (and the WTO's scrutiny) and for the government to show the 'pastoral care' which brought Korea as far as it has come to date. In the end, the statement sheds light on neither issue.

A possible indication of the new strength of the banks in this matter is the report that Korea First Bank and other creditors have insisted that Group chairman, Kim Sun-hong, and other senior executives step down and for the group to sell Asia Motors and Asia Motor Sales Co. in exchange for 160 billion won in emergency loans. Now the creditors and the group are in discussions where the creditors have power, whereas in the past the model was that the creditors were merely instruments of the will of the companies and the government's industry-building policies. As stated frequently, however, the government can not simply 'sit by' and is obliged to offer conciliatory comments about its concern to protect 'the country' against 'disorder'. How this manifests itself, however, in the micro-management of the Kia issue is far from clear.

The Kia bailout is adding further pressure to the creditor banks, whose own financial position is being described in parlous terms. The Bank of Korea has been reported as extending US$3.5 billion to domestic banks to fund bailouts. On July 17, the Bank of Korea reportedly received a request from Korea First Bank for US$1.1 billion in low-interest loans, which has lent nearly US$1 billion to Kia.

The model here is of domestic banks, in an effort to prop up collapsing enterprises in which they have greatly over-extended credit, calling on the central bank for 'up the line' financial protection at preferential rates. This is continuing to fuel concerns that banks will continue to refuse to, in the words of one commentator, "turn off the cash spigot". (*Ref. 'Quaking in Seoul - Now the Banks are in Trouble Too', Business Week, 4 August 1997).*

c. Can Kroll get more information on the role c the Korea Development Bank in the Kia bailout

KDB is one of the ten Korean banks which have agreed to form the 'anti-bankruptcy pact'. A committee formed by member of creditor banks will evaluate each case and measures are said to include continued lending with lower interest rates, filings of court receivership, sales of management rights to third parties and allowance of liquidation procedures.

As at July 16, the creditor situation of Kia Group was as follows:

- Korea Development Bank - 1.296 trillion won
- Korea First Bank - 814.2 billion won
- Cho Hung Bank - 651.1 billion won
- Shinhan Bank - 504.6 billion won
- Boram Bank - 257.2 billion won
- Seoul Bank - 246 billion won
- Commercial Bank of Korea - 236.6 billion won
- Hanil Bank - 230 billion won

At the time of reporting, there is little information, other than that presented above, relating to particular institutions position regarding the Kia bailout. Public announcements have mostly come from the Korea First Bank, the 'host bank' to Kia.

### *3. Intra-Group Lending*

*Some of the chaebol are slowly learning to depend more on their subsidiaries and affiliates. One article stated that the "chaebol often use their financial subsidiaries as sources of cheap funds". An example of this is Samsung which makes use of Samsung Life Insurance's healthy assets totaling 13 trillion won. However, not all of the chaebol can depend on their subsidiaries - Hyundai reportedly lacks strong financial subsidiaries.*

*(Hyundai The Next Fifty, Korea Money July 1997)*

a. Are these financial subsidiaries regulated by the government, if so, are they protected? Can Kroll trace any intra-chaebol subsidization in the form of loans, or loan guarantees by a financial subsidiary or other 'cash cow' affiliate to a chaebol auto company?

Generally, the information available on this subject is not specific, for example:

- Samsung has been financing its entry into the auto world with profits from its huge semiconductor operations. But a glut of chips worldwide has slashed prices, and hence Samsung's chip profits. *(Ref. 'South Korea's auto industry is facing a massive overcapacity problem' - Automotive News, June 30, 1997.)*
- "The chaebols can command huge resources, and the various affiliates subsidize one another" - an example cited is Kia's guarantee to Asia Motors of 869 billion won in loans *(Ref. 'Kia Motors struggles as South Korea's Auto Underdog', Wall Street Journal, 25 June 1997)*

Notes on Supervision of Insurance Companies:
Until a revision of the Insurance Business Act in 1977, administration of insurance was handled exclusively by the Ministry of Finance and Economy. Between 1977 and 1989, that role was held by the Korea Insurance Corporation. In 1989 the Act was amended again, the KIC was dissolved and the Insurance Supervisory Board was established to supervise the industry.

Regarding protection of the insurance companies and the issue of use of funds, particularly in relation to intra-group loans and guarantees, Kroll does not have sufficient information at this point to offer comment.

### *4. Kia Motors - Export Loans*

*This month alone, Kia's creditors have agreed to supply US$ 300 million in export loans to the group. (South Korea: Interview-Kia Group Head Confident. Reuters News Service, Kim Myong-hwan 07Jul97)*

&

*The Ministry of Finance and Economy promised cheap loans to help cash-strained Kia subcontractors. The loans will come from a special fund created this year to keep small businesses from bankruptcy amid the overall economic slowdown. The government said it will ensure that Kia's cash-flow problems don't affect its 10 overseas projects, including its $500 million investment in Indonesia's National Car program. ('Kia Plans Sell-Offs to Ease Cash Squeeze'. The Wall Street Journal Europe 07/17/97)*

**a. What are the export loans that Kia's creditors have agreed to extend; what, if any, role has the government played in securing these 'export loans' for Kia; are the government 'assurances' that Kia's cash-flow problems will not affect its overseas projects in any way related, if so, how; if not, what are the 'assurances', who gave them, and under what authority?**

The first statement was made by a representative of Kia's prime creditor, Korea First Bank, quoted on 7 July 1997. No further details were provided. Important to note, however, is that Korea First Bank, itself, has been forced to take drastic measures for its own financial survival and that the Ministry of Finance was reported to have provided emergency funds of 1 trillion won, via the Bank of Korea, to aid Korea First Bank while it, in turn, helps protect Kia.

The second statement relates to the Ministry of Finance's statements about the Kia situation, including assurances to Kia's subcontractors about protection from any fallout. No detail is provided about how assurances for Indonesia's National Car program will manifest themselves.

With the absence of direct references, a clear statement is difficult to make but it appears clear that the Ministry of Finance is 'propping up' the financial institutions to instigate protective measures which the government, itself, directed and, at least in the case of Kia's subcontractors, is declaring its direct support to protect them against bankruptcy. Whether or not this is the operative concept behind the Korea First Bank's reference to 'export loans' is not clear. Once again, however, a crucial question concerns the shift in reference from 'export loans' to 'assurances of protection against bankruptcy' and whether it can be shown that continued 'funding' is going towards expansion.

### *5. Facility Investment Plan - Loan funds from KDB*

*It is (also) expected that there will be an increase in supply of funds under government directives, such as special financial support for small and medium sized companies and easier access to commercial loans for designated industries of both small and large companies.*

**a. Can Kroll elaborate on this statement; what is the amount of expected funding and to what extent is it directed toward the auto sector?**

This statement is made primarily on the basis of the Korean Development Bank's 'Survey of Facility Investment', May 1997 which provides charts for 1996 actual and 1997 anticipated spending by industry sectors on facility investments. (NOTE: These charts have been provided to the client.)

The notes to these charts explain that, for 1996, most corporations resorted to external financing (by 75.6%) in 1996 and that they are expected to do so again in 1997 (by 79.6%). Corporations dependence on internal financing will continue to be low, mainly due to decreasing profitability. The notes continue to explain forecasts, stating that direct financing through issuance of bonds and stocks will account for 24.1% of total fundings in 1997, compared to 26.5% in 1996, because the companies forecast continuing gloominess in the direct capital markets in 1997. Therefore, it continues, funding reliance on bank loans is expected to increase to account for 55.5% of the total fundings in 1997, from 49.1% in 1996. The statement cited in Kroll's report follows this analysis by referring to "easier access to commercial loans for designated industries" as one of the "government directives" which will encourage a greater dependence on indirect financing. As the charts show, the estimated levels of external financing for the auto industry is 81% of the total estimates for 1997, which stand at 44,428 (by 100 million won).

In other words, the numbers and commentary do not refer to any 'direction' in respect of loans to the auto industry (or any other) - and the notes refer to 'direction' only in so far as policy on commercial loans is subject to lessening restrictions 'by government direction'.

### 6. Restrictions on capital inflows - 1987

*From 1987, following the restrictions on capital inflows imposed due to the shift to the current account into surplus, the proportion of fund raised through foreign-currency borrowings and securities issuance in international markets contracted somewhat, while the raising of domestic funds through capital subscriptions and the issue of Industrial Finance Debentures in domestic markets expanded.*

**a. Were the restrictions designed to protect against a rise in the won/dollar exchange rate; if not, what was their purpose, how long were the restrictions in force, and did they accomplish anything?**

This issue has been incorporated into the section above dealing with Korean government reliance on the financial sector to maintain control over Korea's exchange rate - in short, the restrictions imposed in 1987 did not, in fact, serve to stop the won appreciating against the US dollar. Kroll is otherwise not able at this point to state the actual purpose of the restrictions or their duration.

### 7. Special Banking Acts

*The MOFE controls policy. The 'Special Banking Act' was established to provide funding to key industries such as electronics, ship building and autos.*

**a. Does the Special Banking Act actually provide funding to key industries such as electronics, ship building and autos; if so, how and to what extent?**

This comment was made in an interview with Richard Pyo and Seok Yun, analysts at Credit Suisse First Boston, in Seoul.

There are five 'Specialized Banks' in Korea - The Industrial Bank of Korea, The Korea Housing Bank, The Credit and Banking Sector of the National Agricultural Cooperative Foundation, The National Federation of Fisheries Cooperatives and The Credit and Banking Sector of the National Livestock Cooperatives Federation. Specialized banks are directed and supervised by the government, although with some oversight by the Monetary Board and the Office of Bank Supervision of the Bank of Korea.

Specialized banks' primary purpose is to provide funds to particular sectors whose supply of funds through normal commercial means is insufficient, however, they are described as having expanded their businesses into commercial banking areas and now follow the same pattern of business as commercial banks. Nothing in the literature available on the operations of Specialized Banks, however, deviates from the notion that funds are directed by the government to selected sectors.

Regarding Pyo's specific reference to the auto industry, it remains to identify loan funds from the Industrial Bank of Korea, being the most likely institution for auto sector lending.

At present, the government owns 64.5% of IBK, although it was reported in May 1997 that the government intends to privatize the IBK, and KDB, from July this year. In so doing, the government plans to change their classification for government-invested financial institutions to government-contributed ones, where government-invested institutions are directly controlled by the government in making major decisions.
*(Ref. 'Govt. to Privatize IBK and KDB Beginning July', Korea Economic Daily, 05/13/97)*

To answer this question further, Kroll is attempting to obtain details of lending by the Industrial Bank of Korea to identify auto sector loans, and to obtain clarification from Pyo in his statement.

### *8. Appointment of Officers to Financial Institutions*

**a. Does the Korean government control executive appointments at the major commercial banks; how and by whom?**

There are numerous references to the control the government has over executive appointments and, de facto, the effect this has on the ability of the government to influence bank operations. Much of this material relies on the simple statement of the practice without providing concrete information.

Reference is drawn to the report of the appointment of Young-Tai Kim as governor of KDB on 6 June 1997. *(ref. Asian Wall Street Journal, 06/06/97)* The report states that Kim was previously president of the Korea Tobacco and Ginseng Corp., president of the Korea Land Development Corp. and, before that, vice minister in of the government's Economic Planning Board.

KDB is still a government-invested bank which the government is still only talking about privatizing. As all major decisions of the KDB are 'controlled' by the government, personnel issues are a part of the process and it can be stated that appointment to the bank's senior positions are a matter of government decision. The fact that the new president, Kim, is a former vice minister, therefore, can be interpreted as an example of the government appointment process (ie. the KDB posts are seen as an extension of government posts).

### *Other Appointments*

Further examples of government functionaries occupying senior financial positions include:

- Lee Kyung-Shik - former Deputy Prime Minister under Kim Young-Sam and former Minister of Finance and Economy (1993), now governor of the Bank of Korea
- Lee Dong-ho - former Home Minister, now chairman of the Korea Bankers' Association (note: Lee was one of a number of lawmakers, bankers and others called for questioning over the provision of preferential loans to the Hanbo Group in April 1997 - Lee was one of 33 people called for questioning on the suspicion of having received money from Hanbo to facilitate loans. Lee claimed that he had received a donation from Hanbo's president as a political donation pending the last parliamentary election but declined to state the amount)
- Roo Shee-Yul - former central bank official, now president of Korea First Bank

## 9. Ensuing Enquiries arising from Kia Bailout

The emerging situation involving Kia present some opportunities to explore the issue of the tripartite relationship between the government, banks and, in this case, Kia. Various specific questions have been posed by the client for consideration in the ensuing phase of the assignment. Where possible here, Kroll provides some comment on these questions, without, at this stage, intending such comment to stand for an analysis of the issues:

1. To what extent (if at all) did Kia's capacity expansion lead to excessive debt which, in turn, created a cash flow problem for the Group?

Kroll's initial impression is that this must clearly have been the case, although significant investments in developing new models would have had an influence.

2. Why was the capacity expansion approved by the company?

This question discloses the presupposition that there is anything like a company board resolution process for major decisions, or shareholder's sentiment to consider. In the case of Korean companies, shareholders are largely silent (and, in any case, are largely comprised of Group members). In the case of company decisions, the typical view is that, in accordance with the 'Top-down' way that Korean society works, the chairman's wishes are sacrosanct (this is particularly the popular view of the reason for Samsung's entry into the auto manufacturing sector).

3. What role (if any) did the government's 'vision' for auto sector growth play in the channeling of capital to Kia?

Kroll's view is that the government's development plans were central to the reason for bank lending, for Kia and the other auto companies.

4. Why did major banks (and particularly Korean First Bank) commit so heavily to Kia? (Wasn't the risk evident?)

This question can be asked of a lot of bad loans in Korea. Kia is the third largest automaker in Korea and is strategically important. Risk analysis has not featured heavily in Korean bank lending.

5. To what extent (if at all) was there explicit or implicit government influence in decisions by banks to lend so much to Kia?

This question partially relates, at least in the realm of implicit influence, to question 3.

6. To what extent has the willingness of the Bank of Korea to support the operations of the major banks (eg. by means of an artificially low discount rate) and protect them from collapse led to imprudent lending decisions, such as loans to Kia?

As long as the Bank of Korea extends discount loans to banks like Korea First Bank, which has been the case for many years, the impression is that the 'spigot is perpetually open' for key companies in key industries. The fact that the Bank of Korea is still the source of support and succor to the Korea First Bank as it continues to pour money into Kia would seem to indicate that the Bank of Korea's willingness to supply funds is central to commercial bank's decisions.

7. Has Korea First Bank been unusually close to the Government in terms of cooperation with the Government on industrial expansion programs?

This question finds part of its answer in the testimony provided by Park Sok-tae, a former managing director of Korea First Bank. Park testified in the investigation into the Hanbo collapse that the South Korean Government had instructed the bank to provide almost endless capital to Hanbo. This situation was not, however, unusually weighted towards Korea First Bank as the prevailing view is that, of the six major banks which control 70% of bank flows, the same system of 'acting on instructions' was operative.

8. To what extent does the 1.5 trillion won government fund that has been established to prevent corporate failures encourage banks to continue to lend to groups like Kia?

9. Does this fund allow even bankrupt companies and groups to finance the completion of their plans to expand capacity?

The question whether or not bailout funds are used to continue financing expansion has been identified earlier as an important issue to explore in the ensuing phase of research. Important to note in this context is the announcement, post and despite the bailout announcement, of Kia Motor's intention to raise its investment level from 150 billion won this year to 450 billion won next year. The article noted, however, that Asia Motors may reduce its investment plans to 70 million won to 83 billion won as part of the Kia Group's self-rescue measures.(Ref. Korea Herald, 24 July 1997).

10. What is the significance of the central bank's decision to inject 1 trillion won into the banking system by selling one-day repurchase agreements? (Is it part of an effort to provide funds to Korea First Bank?)

The Bank of Korea is reported to have extended US$3.5 billion (approx. 3 trillion won) in emergency foreign-currency loans to domestic banks in the face of the potential banking crisis to which the Kia bailout is contributing. On the face of it, Kroll would interpret any injection of funds into the banking system by the Bank of Korea at present to be for the purpose of making bailout funds available to affected banks.

### *Errata*

Clarification was sought on two statements made in Kroll's draft Phase Two report:

Re: Statement that "KDB controls foreign exchange loans with are always accompanied by restrictions". This should read "The government places controls over ......."

Re: Statement that "cash flow in Korea is very low still, therefore, government intervention is necessary with programs such as FDI which lends money to the Korean government to distribute as they see fit". This statement was a verbatim account from an interviewee, presented accordingly. The comment is understood to mean simply that the government controls the amount of FDI permitted in Korea and, therefore, de facto the funds flowing from FDI - clearly, the government does not "distribute FDI funds".

### Follow-Up Enquiries for Phase Three

The following is a list of questions / issues which Kroll suggests be the subject of further research in Phase Three of the assignment:

* Government's control of the Bank of Korea

Kroll considers that there will be a lot of attention placed on the Presidential Commission on Financial Reform in the ensuing weeks by the media and industry analysts. Central to such attention should be a critical review of the government's role in the financial system.

* Government control of the Specialized Banks

Under Kroll's impression that, of the Specialized Banks, the Industrial Bank of Korea is the most pertinent one to the auto sector loans. To make sense of overall figures for industry funding by Specialized Banks, Kroll considers that further research needs to be conducted on the Industrial Bank of Korea, especially with regards to its loan portfolio.

* Government 'encouragement' of cooperation from Commercial Banks

Anti-Bankruptcy Pact - Kroll obtained clear statements from commentators that the government was involved in the formation of the pact and it goes further by declaring that the government effectively threatened banks to follow suit.

'Window-Guidance' - This concept is clearly central to the issue of government directed lending and is one for continued research to obtain as much specific detail as possible.

* Government control of exchange rates through financial sector regulation

The degree to which this issue would shed light on government interference in the financial markets makes further research on this issue warranted.

* Funds available from the Industrial Technology Fund

This Fund is clearly not limited to the auto sector but Kroll considers that the amount of funding auto sector companies have received through this mechanism is a worthwhile research aim in Phase 3.

* Preference to auto sector companies in regulatory approvals for financing

At this stage there have been no indications that auto sector companies have been singled out for any particular regulatory approvals in relation to expansion financing. Such approvals would constitute a categorical confirmation that auto companies have received preferential treatment.

* Proportionality of loans to the auto sector

Kroll feels that a study of the relative lending amounts to the auto industry by key institutions, like the Korea Development Bank, would provide useful tool in assessing disproportion.

On a wider analysis, Kroll suggests that a review of production indices for Korea's principal industrial products and their relative contribution to total industrial production could be measured against the relative share of loans to the Motor Vehicle industry from Korean banking institutions (overall). By this method, on a macro-economic level, an assessment may be possible as to whether or not a disproportionate amount of loans are extended to the auto industry.

* Auto sector long-term or short-term loan interest rates and other financing costs compared to other sectors

Such comparison has not yet been conducted but Kroll's impression is that this will be a straightforward exercise with relevant data being derived from financial from a range of Korean industrial sector companies.

* Return on assets and equity of Korean auto companies

* 1991 Credit Control Reform Plan

Details are required on the proposed reforms, the selection criteria for inclusion and the companies which benefited.

* The 'Three Core Businesses' Issue

Further research and analysis on this issue is required to assess the government's motives - whether they be to <u>limit</u> the size and power of the chaebol, or to <u>select</u> 'key' business on which to concentrate development funding.

* Anti-Bankruptcy Pact / The role of the government in the Kia bailout

A key question, in the light of the current study is whether or not the money being released via the anti-bankruptcy pact is being used to fund continued expansion of the effected companies. In the case of Kia Motors, this is especially relevant in the light of Kia's published expectations for financing capacity expansion in the next year, the announcement of US$300 million in 'export loans', and the MoFE's announcement to provide funds for Kia's subcontractors affected by the company's current crisis.

* Intra-Group loans / guarantees

* Government control of banking executive appointments

In line with further research and analysis of the imminent Financial Reform Commission submission, the general issue of the degree to which the government maintains actual and de facto control of banks' lending policies and decisions, includes a review of the number of former civil servants who hold senior banking positions. Some examples are cited but Kroll believes there are many more and that a fuller list will show the trend. (Note: This issue is looked at independently of the government's mandated role in the appointment of senior central bank officials and members of, for example, the Monetary Board.

* Korean language documents

To date, only a few Korean language documents have been translated. Kroll anticipates continuing to obtain full translations of selected documents and subjecting these to analysis. In addition, various additional documents will be sought, particularly relevant information from KAICA Journals (which thusfar appears to be one of the best sources of Korean language information) for translation and review.

* Further questions resulting from the Kia bailout:

(NOTE: Some commentary is provided on these questions in this report, however, more complete answers will be sought in Phase 3)

1. To what extent (if at all) did Kia's capacity expansion lead to excessive debt which, in turn, created a cash flow problem for the Group?

2. Why was the capacity expansion approved by the company?

3. What role (if any) did the government's 'vision' for auto sector growth play in the channeling of capital to Kia?

4. Why did major banks (and particularly Korean First Bank) commit so heavily to Kia? (Wasn't the risk evident?)

5. To what extent (if at all) was there explicit or implicit government influence in decisions by banks to lend so much to Kia?

6. To what extent has the willingness of the Bank of Korea to support the operations of the major banks (eg. by means of an artificially low discount rate) and protect them from collapse led to imprudent lending decisions, such as loans to Kia?

7. Has Korea First Bank been unusually close to the Government in terms of cooperation with the Government on industrial expansion programs?

8. To what extent does the 1.5 trillion won government fund that has been established to prevent corporate failures encourage banks to continue to lend to groups like Kia?

9. Does this fund allow even bankrupt companies and groups to finance the completion of their plans to expand capacity?

10. What is the significance of the central bank's decision to inject 1 trillion won into the banking system by selling one-day repurchase agreements? (Is it part of an effort to provide funds to Korea First Bank?)