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A STUDY OF REAL ESTATE TRUST IN KOREA

Jinu Kim, PhD (corresponding author)
Faculty of the Built Environment
The University of New South Wales
Sydney 2052 Australia
Fax: (+612) 9385-4507
E-mail: J.Kim@unsw.edu.au

Sang-Young Lee, PhD
Construction and Economy Research Institute of Korea
Construction Building 9, 11F
71-2 Nonhuyn-dong, Kangnam-gu
Seoul Korea

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J. Kim and S.Y. Lee

Abstract

In Korea, Real Estate Trust Institutions were introduced in the early 1990's with the purpose of satisfying the burgeoning demands of the property market. The Real Estate Trusts were started in order to prevent the real estate market from speculation and to encourage the efficient use of land. The other purpose of the Real Estate Trusts in Korea was to achieve a competitive advantage in real estate development for local firms.

Despite the above intentions, the Real Estate Trust companies have, in the wake of the Korean economic crisis of 1997, been in difficult situations because of asset deflation and recession. This paper analyses the problems of Real Estate Trust companies in Korea and proposes an alternative solution. As an alternative, the introduction of institutions similar to the Australian Listed Property Trust (LPT) or the U.S. Real Estate Investment Trust (REIT) is considered. This new institution - Listed Real Estate Investment Trust in Korea (K-REIT) - would establish new principles of real estate investment and the securitisation of real estate.

Introduction

After the currency crisis in 1997 and the subsequent financial crisis in 1998, there was a serious credit crunch in Korea. One of the consequences of this was that the two main Real Estate Trust (RET) companies, Korea Real Estate Trust Company (KRET) and Hankook Real Estate Trust Company (HRET), almost went into bankruptcy. Many projects handled by these companies were put on hold. In September 1998, the Finance Supervisory Commission (FSC) found the operations of KRET and HRET to be insolvent. Poor management was cited as a major contributory factor. As a result of this, FSC prohibited new Land Development Trust operations of the two RET companies for six months. In March 1999, the lenders to these RET companies accepted a delay in the repayment of their loans and interest. The FSC extended this delay for a further six months.

If the two RET companies in question had gone into bankruptcy, the financial institutions would have had to underwrite insolvent loans of 1.3 trillion Won (about U$1.1 billion). About 150 apartment complex projects would have been stopped, and more than thirty thousands buyers, supposed to move into the apartments constructed by these RET companies, would have been affected. In the light of these circumstances, the combined forces of the financial institutions and the real estate industry made the decision, to restructure the two RET companies.

The FSC and the Ministry of Finance and Economy (MOFE) prepared a plan that included the transfer of good projects from the two insolvent companies to a new company – Saengbo Real Estate Trust Company (SRET) – which started operations on 1999. The FSC and MOFE considered that all related companies including the parent companies and the financial institutions should share the burden, as they had common liabilities for the insolvency of the RET companies. The parent companies of the RET companies had not properly controlled their affiliated RET companies. The lenders had lent based on corporate guarantees of the parent companies rather than the feasibility of the projects, resulting in excessive loans being made to the RET companies.

On the face of it, the crisis of the RET companies in Korea was due to the currency crisis at the end of 1997 and the credit crunch that followed. The crisis, however, was not only the result of a temporary credit crunch, but also of internal problems in the RET companies. These structural problems can be viewed in a comparison to foreign real estate trust institutions, such as the Australian Listed Property Trust (LPT) and the U.S. Real Estate Investment Trust (REIT).

This paper analyses the experiences and problems of the real estate trust institutions in Korea and concludes by proposing a Listed Real Estate Investment Trust in Korea (K-REIT) which would stabilise the real estate trust institutions and minimise further damage to the economy. Furthermore, this strategy would provide an investment medium in Korean real estate market for international investors.

Real Estate Trust Institutions in Korea – a background

In the 1960's and 1970's, fast economic growth expedited real estate development in Korea. This development worsened the inequality of income distribution and wealth, because a few of the large business groups (*chaebols*) and landowners owned the greater part of the real estate and capital. Because of this, the Korean Government determined to regulate the real estate market, and to levy heavy taxes on real estate capital gains. The Government established a number of policies in order to prevent speculation of real estate market following the skyrocketing prices of real estate in the 90's due to the boom of the late 80's.

The core policy was 'Public Concept of Land' developed in 1989. This concept proposed a set of strong and fundamental measures, the Urban Residential Land Limit Charge, the Land Development Charge, and the Land Value Increment Tax. The objective of these laws was to regulate land use in order to satisfy public welfare, even though private ownership was recognised (Park, *et al.*; 1998:18).[1] When this policy was introduced, the government needed a regulatory mechanism in order to ensure efficient use of land. The new mechanism – the RET company - was introduced to prevent real estate market speculation and to lessen the public development burden through private investment in developing land market.

A second objective of introducing RET companies was to improve the competitive advantage of local firms when Korean construction and real estate markets were opened up for international competition. Otherwise, foreign real estate companies with powerful capital and financial know-how could easily erode the market share of Korean real estate related companies. Hence, the government introduced real estate trust institutions in 1990, and permitted the formation of the RET companies (KRET and HRET) in 1991 (Jung and Choi; 1996:16).

Characteristics of the RET companies

From the onset, the government controlled the real estate trust business by licensing. The requirements of a licence for real estate trust business were, basically, expertise combined with adequate capital, together with a stated intention to work in the public interest. Expertise was defined as an ability to carry out real estate trust business and employ professional staff. Adequate capital was simply the requirement to be a large company that had the credibility to operate a real estate trust business without incurring failure. At the beginning (in 1991), the minimum capital of a RET company was 500 million Won (about US$417,000). This was increased to 10 billion Won

[1] After the Korean economic crisis in 1997, the implementation of 'Public Concept of Land' policy was repelled.

(about US$8.3 million) in 1998.

Among the licence requirements, the most important one was the public interest. To satisfy the requirement for acting in the public interests, an applicant RET company (parent company) for a RET company had to be one of the followings: (1) A Government enterprise or a government funded enterprise. (2) A Company which could be audited directly or indirectly by the National Assembly or the Board of Audit and Inspection. (3) A Company which was government controlled, either directly or indirectly, in the process of licence, product development, public offer, and the articles of association. (Sohn; 1998:353)

Table 1. A Summary of the RET Companies Establishment

	KOREA REAL ESTATE TRUST (KRET)	HANKOOK REAL ESTATE TRUST (HRET)	KOREA REAL ESTATE INVESTMENT TRUST (KREIT)	JOOEUN REAL ESTATE TRUST (JRET)	HOUSING COOPERA-TIVE REAL ESTATE TRUST (HCRET)	SAENGBO REAL ESTATE TRUST (SRET)
Parent company	Korea Asset Management Corporation	Korea Appraisal Board	Korea Land Corporation	Housing & Commercial Bank	Korea Housing Financial Cooperative	Three Life Insurance Companies
Establish ment	1991.4.13	1991.4.13	1996.4.4	1996.12.3	1997.12.15	1998.12.8
Capital (U$)	KW6 bil (U$5 mil)	KW7 bil (U$5.8 mil)	KW50 bil (U$41.7 mil)	KW10 bil (U$8.3 mil)	KW10 bil (U$8.3 mil)	KW10 bil (U$8.3 mil)
Share holders of the Parent Company (%)	Govt.: 33.3 KDB: 33.3 Others: 33.3	Govt.: 49.4 KDB: 30.6 Others: 20.0	Govt.: 92.9 KDB: 7.1	Govt.: 22.4 ESOP: 9.8 KSD: 63.1 Individual: 4.1 Seoul Bank: 0.6	Association of more than 1,400 housing construction companies	Private Shareholders

Note: KDB: Korea Development Bank. Others: Financial Institutions.
ESOP: Employee Stock Ownership Plan. KSD: Korea Securities Depository.
Source: Sohn (1998:357)

Table 1 shows a summary of the RET companies established in Korea. Currently there are six RET companies, Korea Real Estate Trust Company (KRET), Hankook Real Estate Trust Company (HRET), Korea Real Estate Investment Trust Company (KREIT), Jooeun Real Estate Trust Company (JRET), Housing Cooperative Real Estate Trust Company (HCRET), and Saengbo Real Estate Trust Company (SRET). All RET companies except SRET are companies affiliated with the government agencies. KRET, HRET, and KREIT were established by government enterprises, Korea Asset Management Corporation (KAMCO), Korea Appraisal Board (KAB), and Korea Land Corporation (KLC), respectively. JRET and HCRET were established by the Housing and Commercial Bank (HCB) (government funded enterprise) and Korea Housing Financial Cooperative (KHFC) controlled by the government, respectively. The government only allowed the public companies to establish the RET companies in order to safeguard public interests and to minimise the negative side effects of speculation in real estate market. However, after the Korean economic crisis, the government allowed the private insurance companies to establish SRET.[2] It

[2] Saengbo Real Estate Trust Company (SRET) is a private company established by three insurance companies. (equity capital ratio; Kyobo 0.5, Samsung 0.4, Heungkook 0.1)

was expected that the private funds and the advanced management skills of private companies would revitalise the real estate market.

Scope of Real Estate Trust Business

There are two types of trust – a money trust and a real estate trust – depending on the type of entrusted property. By regulation, Real Estate Trusts can only deal with real estate. The landowners entrust their real estate to the RET companies, which develop, manage, and/or dispose the entrusted real estate. They arrange loans from financial institutions for landowners (beneficiary) with entrusted real estates as collateral. Because the RET companies cannot raise the funds by themselves, they rely on borrowing from outside when they need additional funds.

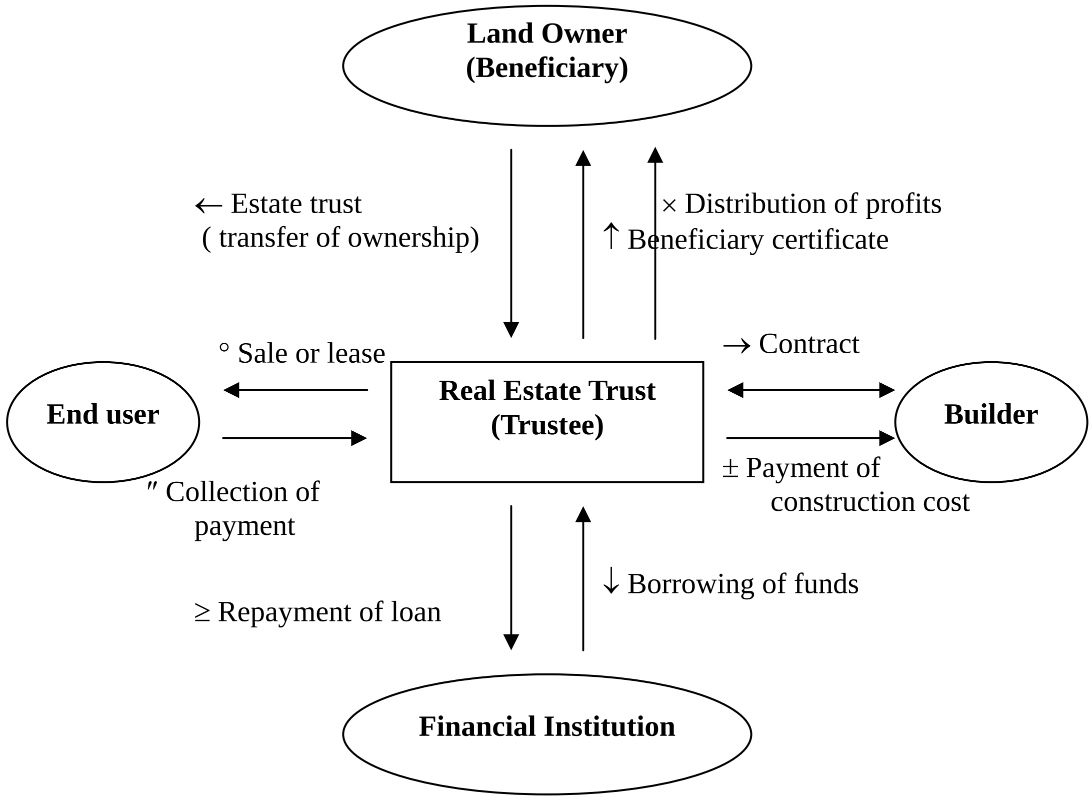
There are four major types of real estate trust categories; *management trust*, *disposal trust*, *land development trust*, and *collateral trust*. A *management trust* is a vehicle where the trustee (RET company) manages the entrusted real estate for a beneficiary. A *disposal trust* is designed to dispose of the real estate safely and quickly for a beneficiary. A *collateral trust* is a vehicle, which allows a beneficiary to use real estate as collateral for finance.[3] A *land development trust* is designed to develop entrusted land for a beneficiary. The RET companies develop the entrusted land as a housing complex or land subdivision, and then return profits to beneficiaries after sale or lease of the developed real estate. *Land development trusts* can be classified into two types; for sale and for lease. The former distributes profits to beneficiaries after selling the developed real estate in lots. The latter returns the developed real estate and rental incomes to beneficiaries after leasing.

When they were initially established, RET companies operated *management trusts* and *disposal trusts*. *Land development trusts* and *collateral trusts* were then introduced in November 1992 and February 1993, respectively. From January 1994 public land owned by the central government could be entrusted to RET companies. In 1999, public land owned by the local governments was included in *land development trust* business. In the beginning, the RET companies concentrated on *management trust*, *disposal trust*, and related businesses only. Later however they focused on *land development trust* business.

Figure 1 shows basic elements and structure of *land development trusts*. As all participants – beneficiary, trustee, constructor, financial institution, and end users – were satisfied with *land development trust* business, it became the main business of the RET companies. For the beneficiaries (landowners), the vacant or under-developed lands could be developed without their own funds by the RET companies who could manage the constructors and other related parties effectively. For the trustees (RET companies), large-scale and short-term *land development trust* business provided more profitability than other trust businesses, because its fee was bigger than that of other trust businesses.[4] For the constructors, *land development trust* was a useful financing vehicle. Financial institutions regarded the RET companies as creditable borrowers for the following reasons. Firstly, a *land development trust* project would continue even though the constructor went into bankruptcy. Secondly, the RET companies were backed up by the creditability of the parent companies. Thirdly, the financial institutions could, in the worst case, recover the loans by selling the lands. End users (buyers) also regarded *land development trust* projects as safe, because the RET company was project manager.

[3] *Collateral trust* has advantages of cost, management, and disposal in comparison with the fixed collateral of financial institutions. (Korea Institute of Finance;1999:14)
[4] During the construction period, the fee of *land development trust* is within 5 per cent of the value of entrusted real estate plus construction cost. After the construction, the fee is within 10 per cent of annual rental incomes or 5 per cent of sale price. (KREIT;1997:12)

Figure 1. Basic Elements of the Land Development Trust



Size of Entrusted Real Estate and the Profitability

Currently, the RET companies in Korea concentrated their business on *land development trusts* and *collateral trusts*. The portion of *management trusts* and *disposal trusts* to the total amount of the entrusted real estate was less than 10 per cent in 1997. In 1992, the total number of real estate trusts was 33 cases, and total amount of entrusted real estate was 18.6 billion Won (U$15.5 million). In 1997 year of the Korean economic crisis, total number reached 394 cases, and total amount was 3.7 trillion Won (U$3.1 billion). In particular, the *land development trust* was 36.3 per cent of total amount of entrusted real estate in 1997.

As Table 2 shows, the total amount of entrusted real estate increased after the economic crisis. In 1998, total number and amount of entrusted real estate reached 711 cases and 8.3 trillion Won (U$6.9 billion). This was due to the increase of *guarantee trust*[5] business started in 1998. *Collateral trust*, 81 cases (54.4 per cent of total real estate trust) and 2.2 trillion Won (U$1.8 billion) (75.1 per cent of total real estate trust) was the second largest. The next was the *land development trust*, with 26 cases (17.4 per cent), 171.5 billion Won (U$142.9 million). However, as

[5] *Guarantee trust* is the specific business of Housing Cooperative Real Estate Trust Company (HCRET), which is that the land of project is entrusted for the guarantee of sales by HCRET.

Table 3 shows, the number of cancelled trust business reached 96 cases and the amount 1.4 trillion Won (U$1.2 billion) in 1998.

Table 2. Total Entrusted Real Estate by Trust Business

Unit: million Won (U$ million)

	1992		1993		1994		1995		1996		1997		1998	
	No	Amount	No	Amount	No	Amount	No	Amount	No	Amount	No	Amount	No	Amount
Land Development Trust	-	-	4	11,419 (9.5)	8	26,365 (22.0)	25	203,001 (169.2)	72	599,719 (499.8)	165	1,352,342 (1,127.0)	26	171,549 (143.0)
Management Trust	6	2,719 (2.3)	33	54,228 (45.2)	43	47,305 (39.4)	52	165, 332 (137.8)	69	225,457 (187.9)	15	125,645 (104.7)	28	411,209 (342.7)
Disposal Trust	9	15,925 (13.3)	11	85,395 (71.2)	24	42,659 (35.6)	43	28,843 (24.0)	69	371,016 (309.2)	108	181,881 (151.6)	14	143,180 (119.3)
Collateral Trust	-	-	26	12,923 (10.8)	87	128,222 (106.9)	75	144,854 (120.7)	16	60,907 (50.8)	64	2,069,401 (1,724.5)	81	2,187,321 (1,822.8)
Guarantee Trust	-	-	-	-	-	-	-	-	-	-	-	-	406	5,432,867 (4,527.4)
Consulting & etc. service	18	-	44	-	84	-	78	-	59	-	42	-	156	-
Total	33	18,644 (15.6)	118	163,965 (136.7)	246	244,551 (203.9)	273	542,030 (451.7)	285	1,257,099 (1,047.7)	394	3,729,269 (3,107.8)	711	8,346,126 (6,955.2)

Table 3. New Contracts and Cancellations of Real Estate Trust in 1998

Unit: Million Won, (U$ million)

	New Contracts		Cancellations	
	No.	Amount	No.	Amount
Land Development Trust	26 (17.4%)	171,549 (5.9%) (U$143.0 mil)	23 (24.0%)	271,920 (19.5%) (U$226.6 mil)
Management Trust	28 (18.8%)	411,209 (14.1%) (U$342.7 mil)	10 (10.4%)	96,670 (6.9%) (U$80.6 mil)
Disposal Trust	14 (9.4%)	143,180 (4.9%) (U$119.3 mil)	34 (35.4%)	44,587 (3.2%) (U$37.2 mil)
Collateral Trust	81 (54.4%)	2,187,321(75.1%) (U$1,822.8 mil)	29 (30.2%)	983,313 (70.4%) (U$819.4 mil)
Total	149 (100%)	2,913,259 (100%) (U$2,427.8 mil)	96 (100%)	1,396,490(100%) (U$1,163.8 mil)

Source: Korea Institute of Finance (1999:28)

Since 1995, *land development trusts* have doubled or tripled every year. From 1992 to 1997, there were 284 cases of *land development trust* and the total amount of 2.2 trillion Won (U$1.8 billion). After the economic crisis, the number of *land development trust* decreased from 165 cases of 1997 to 26 cases of 1998. As Table 4 shows, there were 223 cases of sale type in *land development trust* and 87 cases of lease type, between 1993 and 1998. The number of sale type was three times of lease type cases. However, the number of sale type was decreased dramatically in 1998, while the number of lease type was increased. There were 131 cases of apartment (42.3 per cent) and 55 cases of shopping centre (17.7 per cent) (Korea Institute of Finance, 1999:30). If residential and commercial complex buildings were regarded as apartments, the number of apartments became 156 cases.

There were 171 projects (55.2%) with project cost (except land price) of more than 20 billion Won (U$16,7 million). This means that more than half of *land development trust* in numbers was large-scale developments. Project cost more than 100 billion Won (U$83.3 million) reached 20 cases. In particular, the 19 cases of more than 100 billion Won were sale type trust. (Korea Institute of Finance, 1999:32) In summary, majority of *land development trusts* were short-term, large-scale, and sale-type apartment development projects.

Table 4. Number of 'Land Development Trust' by Types

Unit: Number, (%)

	1993	1994	1995	1996	1997	1998	Sub-total	Total
Lease type	3 (75.0)	2 (25.0)	11 (44.0)	18 (22.0)	33 (20.0)	20 (76.9)	87 (28.1)	310 (100.0)
Sale type	1 (25.0)	6 (75.0)	14 (56.0)	64 (78.0)	132 (80.0)	6 (13.1)	223 (71.9)	

Source: Korea Institute of Finance (1999:29)

As the demand for Real Estate Trusts increased, the profitability rapidly improved. According to the trust system in Korea, the performance of the Real Estate Trusts was assessed not by trust account, but by company account. As Table 5 shows, the operating incomes of the RET companies' accounts were increased from 1.6 billion Won (U$1.3 million) in 1993 to 56.6 billion Won (U$47.2 million) in 1998. In 1991, the operating incomes from consultation were the main source of total incomes. After 1995, most operating incomes were generated from *land development trusts.* Between 1993 and 1998, 71 per cent of total operating incomes were generated from *land development trusts*. However, after the Korean economic crisis, the operation incomes from *land development trust* decreased while the operation incomes from *collateral trust* rapidly increased.

Table 5. Operating Incomes by Real Estate Trust Business (Company Account)

Unit: Million Won (U$ thousand)

	1993	1994	1995	1996	1997	1998	Total
Land Development Trust	258 (215)	2,321 (1,934)	8,371 (6,976)	24,223 (20,186)	42,659 (35,549)	33,540 (27,950)	111,372(71.0%) (92,810)
Management Trust	81 (68)	222 (185)	740 (617)	560 (467)	466 (388)	326 (272)	2,395(1.5%) (1,997)
Disposal Trust	139 (116)	220 (183)	307 (256)	320 (267)	928 (773)	497 (414)	2,411(1.5%) (2,009)
Collateral Trust	38 (32)	433 (361)	828 (690)	338 (282)	6,582 (5,485)	19,313 (16,094)	27,532(17.6%) (22,944)
Consultation	1,077 (898)	3,438 (2,865)	1,434 (1,195)	2,466 (2,055)	1,671 (1,393)	2,964 (2,470)	13,050(8.3%) (10.876)
Total	1,593 (1,329)	6,634 (5,528)	11,680 (9,734)	27,907 (23,257)	52,306 (43,588)	56,640 (47,200)	156,760(100%) (130,636)

Source: Korea Institute of Finance (1999:38)

As Table 6 shows, the total net incomes of the RET companies were negative in 1991. But after the rapid improvement, it became 8.6 billion Won (U$7.2 million) in 1997. Return on Asset (ROA) was negative until 1993. From 1994, ROA turned into positive (12.3 per cent) and it was 17.8 per cent in 1995. From 1996 to 1997, ROA decreased, because of the new RET companies (KREIT and HCRET). However, ROA increased in 1998 because of the following reasons. Firstly, the moratorium of interest payments without the closure of insolvent trusts lessened the financial costs for the RET companies. Secondly, the operating incomes from *collateral trusts* were increased. Return on Equity (ROE) increased from 15.2 per cent in 1994 to 23.3 per cent in 1995. This means that the RET companies gained enormous profits before the economic crisis.

Table 6. Profitability of Real Estate Trust Companies

Unit: Million Won (U$ million)

	1992	1993	1994	1995	1996	1997	1998
Total Asset	7,494 (6.2)	7,770 (6.5)	9,729 (8.1)	13,405 (11.2)	54,503 (45.4)	143,788 (119.8)	156,542 (130.5)
Equity Capital	6,300 (5.3)	6,729 (5.6)	7,857 (6.5)	10,262 (8.6)	45,589 (38.0)	90,053 (75.0)	106,384 (88.7)
Net Income	-2,457 (-2.0)	-1,571 (-1.3)	1,198 (1.0)	2,391 (2.0)	4,367 (3.6)	8,578 (7.2)	18,495 (15.4)
ROA (%)	-32.8	-20.2	12.3	17.8	8.0	6.0	11.8
ROE (%)	-39.0	-23.3	15.2	23.3	9.6	9.5	17.4

Source: Korea Institute of Finance (1999:40)

However, the above-mentioned outcome of the operating income, ROA, and ROE resulted from the separation of company account and trust accounts. When a company account included the short-term loans of trust accounts, ROA and ROE would be decreased on a large scale. Since 1998, the government changed the accounting standard of RET companies, and company account must now include the short-term loans of trust accounts.[6]

Financing and Operation

The Real Estate Trust Code 11 of the Ministry of Finance and Economy (1991) states that the RET companies are able to finance the project funds using the following methods: (1) Loans from banks and insurance companies. (2) Loans from trust companies. (3) Loans from various funds. (4) Entrusted funds and trustee's own funds. (5) Loans from construction companies. (6) Business funds such as sale or lease deposit. (7) Advanced funds of real estate development. (8) Other methods approved by the FSC. The RET companies are not allowed to raise funds through issuing shares or receiving money trusts. As a result, financing of the RET companies depends on borrowing from financial institutions. The RET companies principally finance funds from merchant banks. In this case, finance is arranged through discount on short-term (3 to 6 months) Commercial Paper (CP) of the RET companies. As Table 7 shows, the total amount of debts for the period from 1993 to 1997, in the RET companies was 2,379.7 billion Won (U$1,983 million). The main sources of financing were commercial banks - 494.2 billion Won (U$412 million) (20.8 per cent) - and merchant banks - 1,704.3 billion Won (U$1,420 million) (71.6 per cent). The amount of debts reached 2.8 trillion Won (U$2.3 billion) at the end of 1998.

Table 7. Amount of Financing by Financial Institutions

Unit: Billion Won (U$ million)

[6] On Table 6, the new accounting standard is not used in 1998 to keep consistency.

	1993	1994	1995	1996	1997	Total
Commercial Bank	2.2 (1.8)	5.7 (4.8)	42.4 (35.3)	24.6 (20.5)	419.3 (349.4)	494.2 (20.8%) (411.8)
Merchant Bank	-	43.5 (36.3)	69.8 (58.2)	433.8 (361.5)	1,157.2 (964.3)	1,704.3 (71.6%) (1,420.3)
Others	0.6 (0.5)	0.1 (0.1)	1.6 (1.3)	5.1 (4.3)	173.8 (144.8)	181.2 (7.6%) (151.0)
Total	2.8 (2.3)	49.3 (41.2)	113.8 (94.8)	463.5 (386.3)	1,750.3 (1,458.5)	2,379.7 (100%) (1,983.1)

Source: Korea Institute of Finance (1999:44)

The reasons why the RET companies preferred to finance the short-term loans from merchant banks were as follows. Firstly, the interest rate was around 12 per cent to 13 per cent through the CP discount from the merchant banks, while the interest rate of trust loans was around 14 per cent to 15 per cent before the Korean economic crisis. Secondly, because *land development trusts* that needed financing were capable to repaying debts with the advanced deposits, the RET companies preferred short-term loans. Thirdly, the RET companies could arrange financing only with the credit backed by the parent companies and the stability of the real estate trust institutions, because the RET companies cannot provide entrusted real estate as collateral. (Sohn; 1998:362)

Management trust, disposal trust, and *collateral trust* did not need financing due to the nature of trust business. But, *land development trust* businesses require the most of financing in terms of development projects. Hence, the debts of the RET companies should be separated to individual trust account. This in turn means that the RET companies should arrange financing only with the value of entrusted real estate and the viability of the projects. However, the RET companies borrowed the loans through company account with company credit.

Role and Problems of the Real Estate Trust Institutions

The RET companies were growing rapidly until the Korean economic crisis, and profitability was very high. During this growth period, the RET companies carried out various social functions. Firstly, the RET companies contributed to the efficient land use and the revitalisation of land. They functioned as a private agent of real estate development, while public agents generally would not be accepted as developers in Korean real estate market. Secondly, the RET companies enhanced competitiveness of local developers in real estate market. The RET companies improved transparency of real estate business and the new financing methods. Thirdly, the RET companies contributed to the housing supply through *land development trusts* for apartments. They also played the role of intermediates between landowners and constructors coordinating the conflict of interests, and sharing loss and risk. (Sohn; 1998:350-351)

Nevertheless, the RET companies were in financial difficulties after the Korean economic crisis. Firstly, because of the domestic credit crunch following the currency crisis, made it impossible for the RET companies to finance necessary funds. Whilst new loans were suspended, and the pressure of repayment increased, the interest rate rose to around 35 per cent. Due to this credit crunch, the RET companies that borrowed short-term loans, encountered very difficult situations. Secondly, because of the interruption of financing, the projects of *land development trusts* were suspended. As a result, the values of projects were reduced, and the projects became worthless. The bankruptcy of constructors worsened the loss of the projects. Thirdly, due to asset deflation after the credit crunch, the profitability of *land development trusts* were forecasted unfavorably. Hence, some of the RET companies almost went into bankruptcy.

Although those financial difficulties were generated by the external elements, the fundamental causes were the structural problems of the RET companies. The structural problems of the RET companies were as follows:

(1) The RET companies were controlled by the public administration and were not managed according to market principles. The public entities backed by the government agencies were primarily used as credibility to finance from financial institutions. Despite of the code of separate trust account, the RET companies borrowed the funds with the company credit and payment guarantee by the parent companies. Therefore, during the period of credit crunch, not only the projects in trusts, but the RET companies as a whole went into a risky situation.

(2) The RET companies were prohibited from financing through issuing shares or receiving money in customers' accounts. Although beneficiary certificates that guaranteed dividends from entrusted real estate were issued, the certificates were illiquid. Therefore, the entrusted land was the only equity capital of the *land development trust* and the remainders were loans. This business structure of Real Estate Trust exposed the RET companies to liquidity and interest risks. There was no securitisation of real estate to hedge these risks.

(3) As the RET companies tried to satisfy mainly the parent companies' interests, there were conflicts of interests between the Real Estate Trust (trustee) and landowners (beneficiaries), and between the Real Estate Trust and financial institutions. Although the principles of separate trust accounts and sharing risks were instituted, the RET companies actually did not follow those principles. There was no system to control the RET companies by landowners and financial institutions against conflict of interests. Although the RET companies were able to manage real estate in long-term, they concentrated on *land development trusts* of high-profit and short-term sale type projects. The RET companies therefore focused mainly on high-risk and high-return projects.

(4) The government, which should supervise the RET companies, was blamed for mis-management of them. The government not only neglected the structural problems before the economic crisis, but also left the disease untreated after the suspension of *land development trust* projects. As results of this policy, things went from bad to worse. When the values of the projects decreased, it was more difficult for the government to restructure the RET companies. The RET companies were regarded as financial companies by regulation, but they had a combined function of financing and construction for entrusted property. Therefore, the supervision system of them was confused. While the MOFE took charge of permission, mergers and acquisitions, dissolution, and liquidation of the RET companies, the FSC took charge of general business of them. As the RET companies were affiliates of the government agencies, the government supervised them as the affiliates. For example, while the parent companies of two RET companies (KRET and JRET) were under the supervision of the FSC, those of three RET companies (HRET, KREIT, and HCRET) were under the supervision of the Ministry of Construction & Transportation (MOCT). This overlapping of supervision mechanisms caused confusion in policy for the RET companies. Currently, MOCT, MOFE, and FSC control the RET companies and the parent companies. This complexity of control mechanism needs simplification.

Alternatives: the Introduction of Listed Real Estate Investment Trust (K-REIT)

Although the RET companies were introduced as real estate trust institutions, they actually functioned as not real estate trusts, but real estate development companies. The RET companies developed real estate with loans from the financial institutions. The RET companies had the same business mechanism as the construction companies that were affiliates of c*haebols*, the characteristics of which were guarantee of repayment and short-term capital gains in real estate development business. On the other hand, the RET companies as financial institutions supplied the funds to risky land development businesses. Hence, after the Korean economic crisis, the RET companies encountered the crisis of bankruptcy due to undertaking hazardous and high risk of development projects.

Currently, the government and the lenders are planning to restructure the RET companies in order to solve the above-mentioned problems. Certainly, restructuring of the insolvent RET companies (KRET and HRET) is an urgent problem. However, the restructuring has been delayed for the last one and half years and there were two major reasons for this delay. Firstly, it has not yet been decided how the participants of the projects should share the burdens of bad trusts. Second, the valuation method of the individual project has not yet been decided. These problems have delayed the restructuring of the RET companies. Unanswered questions include whether the projects should continue or not, and who should be the project owner. For the former problem, the priority order among the participants - landowners (beneficiary), RET company (trustee), parent companies, and financial institutions – should be decided according to one's stake-holding in the project. If buyers and subcontractors are already involved financially, then these secondary participants should be included in this priority order. For the latter problem, it is necessary to decide on a valuation method, which estimates the value of the project on the basis of land price, input value, and future cash flow. The Resolution Trust Corporation (RTC) in U.S. developed the method of Derived Investment Value (DIV) in the disposal process of the insolvency problems of Savings and Loan Associations (S&L) (FDIC; 1998:391). The Real Estate Trust in Korea needs a valuation method for its disputed projects such as DIV.

Once these problems have been solved, the government should restructure the RET companies using similar methods to those used in restructuring other financial institutions. The good trust accounts should be distinguished from the bad ones, and the former should be continued. The government should prevent the RET companies from bankruptcy through the bad accounts liquidation or by handing over to the Korea Asset Management Corporation (KAMCO).

Moreover, the government and related industries should determine how to improve of the real estate trust institution and management, separately from the restructuring process. Firstly, the focus of public welfare should be changed to market principles. After the Korean economic crisis, the RET companies could not do business like government agencies any more, and the financial institutions could not lend funds on solely on the collateral of real estate. Instead, market principles should be applied, and lending money based on the profitability of the project should be implemented. This trend would change how the real estate trust institutions do business. The securitisation of real estate such as project finance, money trust, issuing certificate note, and financing through Special Purpose Company (SPC) should be considered.

Furthermore, the government should consider introducing the Listed Real Estate Investment Trust in Korea (K-REIT), on similar lines to the Real Estate Investment Trust (REIT) in U.S. or Listed Property Trust (LPT) in Australia. Because the existing Real Estate Trust was operated as a trust, the Australian model of a LPT system should be considered for securitisation of real estate in Korea. If REIT or LPT were introduced as new real estate trust institutions in Korea, *land development trusts* would be changed into K-REIT and the other types of Real Estate Trust would be transferred to KAMCO. The K-REIT would not only strengthen the liquidity of the assets, but also prevent moral hazard through corporate governance. As the existing real estate trust institutions have a serious problem of improper disclosure or corporate governance,[7] the K-REIT is

[7] There is no disclosure requirement of financing in the RET company (Lee, M; 1998:113).

regarded as an alternative.

In terms of listing the Real Estate Trust, the information on the RET companies' business should be disclosed. After listing, the corporate governance should be established in order to guarantee profitability and security. In LPT, the corporate governance was institutionalised together with the disclosure requirements. Managers can be retired by vote of the unit-holders in the event that they fail to meet their obligations. Most of transactions between the manager and the trust should be governed by disclosure requirements and require ratification by unit-holders as well as the trustee, in the case of major investment or capital expenditure decisions (Kim; 1998). This mechanism should be incorporated into K-REIT.

Finally, the government should allow tax benefits to the new institution (K-REIT). In the case of trust business in Korea, the amount of tax evasion was smaller than that of other businesses, because of reporting the correct business incomes to the tax office. Because the tax benefits are the determinant factors of real estate investment, they should be given to the trust business (Lee, M; 1998:113). There was a consensus to remove double taxation in K-REIT, as is the case with the existing mutual funds. The capital gains tax in K-REIT should be reviewed so as to be levied in the case of more than 30% transaction gains for some periods, in a similar fashion to the U.S. These tax benefits are desirable in order to establish the new institution in Korea.

It is debatable whether the heavy taxes on real estate in Korea should be cut or not. In 1995, the ratio of tax liability of real estate to total tax revenue in the holding stage was 4.3 per cent, while the ratio in the transactional stage amounted to 11.6 per cent (Ro; 1998:32). When Special Purpose Company (SPC) was introduced in Korea on 1998,[8] there were tax benefits of real estate transactions. But, it was really difficult for the local governments to allow the tax reduction on real estate transactions, because they faced a fiscal difficulty after the Korean economic crisis.

The proposition outlined above is of course speculative and is not necessarily the only solution. One thing that is clear however is that the real estate industry in Korea is at a watershed and has a unique opportunity to put in place fundamental structural changes which will encourage the internationalisation of the industry. For this to happen it is essential that there is greater transparency of procedures and accountability for actions amongst the major players.

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[8] Korea and Japan enforced the SPC law at the same time in September 1998. The difference between two countries is as follows. While Japan allows a stock company to be listed in the stock exchange market, Korea allows only a limited company not to be listed. Hence, SPC in Japan could function as listed real estate investment vehicle (J-REIT), and SPC in Korea could only liquidate bad debts and real estate.

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