Observations on Current Financial Policy Issues in Korean Banking Industry

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Michael Hellbeck
Agenda

- Current Status / Outlook of Korean Banking Sector
- Observations on Domestic Financial Policy Agenda
  - SME support
  - Household debt resolution
- Comments on Advancement of Financial Industry
- Comments on FX Market Liberalization
Declining Profitability in Korean banking industry

Return on Equity – Korean Banks

2011 ROE comparison by region

<table>
<thead>
<tr>
<th>Latin America</th>
<th>Asia*</th>
<th>Korea</th>
<th>Other developed</th>
<th>US</th>
<th>Europe</th>
</tr>
</thead>
<tbody>
<tr>
<td>19</td>
<td>17</td>
<td>8.9</td>
<td>10</td>
<td>7</td>
<td>0</td>
</tr>
</tbody>
</table>

* Asia : Without Japan and Australia

Net Interest Margin (NIM)

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012 Q3</th>
</tr>
</thead>
<tbody>
<tr>
<td>NIM</td>
<td>2.59</td>
<td>2.81</td>
<td>2.61</td>
<td>2.44</td>
<td>2.3</td>
<td>1.98</td>
<td>2.32</td>
<td>2.3</td>
<td>2.06</td>
</tr>
</tbody>
</table>

Return on Assets (RoA)

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012 Q3</th>
</tr>
</thead>
<tbody>
<tr>
<td>RoA</td>
<td>0.85</td>
<td>1.27</td>
<td>1.13</td>
<td>1.10</td>
<td>0.48</td>
<td>0.40</td>
<td>0.54</td>
<td>0.66</td>
<td>0.43</td>
</tr>
</tbody>
</table>

Stock Price to Book Value

- Korean banks are trading at average of 0.7x Price-to-Book Value
- Bank profitability is expected to deteriorate further going forward
Outlook for Korean Banking Sector

- **The Sector Outlook is bleak**
  - High competition across all segments of consumer banking
  - Irrational pricing of loans and deposits
  - Mortgage loan rates and margins are at historic lows

- **Banking Profitability will decline further**
  - High profit levels in 2010 / 2011 were influenced by large one-off gains on disposal of restructured / recovered company shares
  - Banks are burdened with increasing cost for “social contributions”
  - Banks are exposed to high interest rate market risk from “conforming loans”
  - Korean banks tend to be viewed as “public utilities” rather than commercial enterprises

- **Declining shareholder returns**
  - Korean banks’ RoE is lowest in Non-Japan Asia
  - Banks are not earning their cost of equity (10-12%)
  - With sector profitability declining, who will invest additional capital in Korean banks?
## Observations on SME Support

### Current Support
- Due to Korea’s historical dominance of conglomerates, there is wide consensus that SME need policy support
- Outstanding volume of credit guarantees for SME bank loans is: KRW70 trillion (= 5.7% of GDP) as of 2011
- SMEs tend to rely on credit guarantee support forever
- SME Funding is 99% relying on bank loans
- 16.6% of SMEs have Interest Coverage Ratio < 1x for 3 consecutive years*
- SMEs have limited access to capital markets
- SMEs hesitant to graduate into “large” companies

### Future Direction
- Expand policy support for export oriented and innovative SMEs
- Reform regulations and tax policies that inhibit growth
- Creation of policy support scheme for medium size enterprises (300-1,000 employees)
- Commercial banks are competing for SME clients, with or without public pressure
- How to enable SME’s to eventually operate without guarantee support
- Use well established ABS framework to structure SME CLOs and CBOs
- Develop Venture Capital and High Yield bond market

* As of 2011 1H, 2012 January BOK Report
Observations on Household Debt

Cost of Debt is an increasing concern

Household Debt Trend

(Unit: KRW Trillion)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total household debt</th>
<th>Bank</th>
<th>Non Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2004</td>
<td>100</td>
<td>100</td>
<td>0</td>
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<tr>
<td>2005</td>
<td>200</td>
<td>200</td>
<td>0</td>
</tr>
<tr>
<td>2006</td>
<td>300</td>
<td>300</td>
<td>0</td>
</tr>
<tr>
<td>2007</td>
<td>400</td>
<td>400</td>
<td>0</td>
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<tr>
<td>2008</td>
<td>500</td>
<td>500</td>
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<td>2009</td>
<td>600</td>
<td>600</td>
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</tr>
<tr>
<td>2010</td>
<td>700</td>
<td>700</td>
<td>0</td>
</tr>
<tr>
<td>2011</td>
<td>800</td>
<td>800</td>
<td>0</td>
</tr>
<tr>
<td>2012</td>
<td>900</td>
<td>900</td>
<td>959.4</td>
</tr>
</tbody>
</table>

Average Lending Late and loan balance

<table>
<thead>
<tr>
<th>FI</th>
<th>Mort.</th>
<th>Non Mort.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank</td>
<td>4.63%</td>
<td>7.43%</td>
</tr>
<tr>
<td>Capital</td>
<td>5.4~10%</td>
<td>24~26%</td>
</tr>
<tr>
<td>Savings Banks</td>
<td>9~11%</td>
<td>28~29%</td>
</tr>
<tr>
<td>Credit card</td>
<td>N/A</td>
<td>20-25%</td>
</tr>
<tr>
<td>Money lenders</td>
<td>N/A</td>
<td>39%</td>
</tr>
<tr>
<td>Non Bank (As of 2012)</td>
<td>Savings Banks</td>
<td>9~11%</td>
</tr>
<tr>
<td>Credit finance</td>
<td>39.6%</td>
<td>39.6%</td>
</tr>
<tr>
<td>Total</td>
<td>959.4</td>
<td>959.4</td>
</tr>
</tbody>
</table>

* Source: BoK

Observations

- Bank loan growth slowed since 2011
- Fixed rate loans on the rise
- “Bullet Loans” (interest only) on the decline
- Multiple loan borrowers resorting to high-interest loans in secondary sector is a key concern
- Big gap in unsecured loan pricing between banks and secondary sector
- Announcement of “National Happiness Fund” is a ‘double-edged sword’ (moral hazard issues) but we support KAMCO approach
- Personal Debt Rehabilitation System filing increased
Unintended consequences of tight LTV rules

**Observations**

- Korea’s restrictive loan-to-value (LTV) regulations protected the health of the banking sector.
- But unintentionally harmed middle income households who seek additional funding from non-bank lenders which charge higher interest rates.
- Interest rate cost rise rapidly beyond 50% LTV.
- Temporarily loosening bank LTV ratios for primary residence finance could be considered (on fixed rate basis, refinancing higher cost loans).

**Exhibit 28**

**South Koreans pay a higher premium for high loan-to-value loans**

*2012*

<table>
<thead>
<tr>
<th>Lowest mortgage rate available (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>South Korea</strong></td>
</tr>
<tr>
<td><strong>Netherlands</strong></td>
</tr>
<tr>
<td><strong>United States</strong></td>
</tr>
</tbody>
</table>

*Source: Misermoney.nl, bankrate.com; NICE report; expert interviews; McKinsey Global Institute analysis.*
For banks to fulfill their social responsibilities and meet public demands, they need to generate profits and raise their stock price to attract more investment.

- Only profitable banks will expand and create more jobs, which is the most important social responsibility.
- Banks should not be viewed as a ‘public utility’ but as an industry in its own rights.
- Promote larger banks with investment banking capabilities that can advance into global markets, following their clients.

Designate financial sector as a priority growth sector since it has multiplier effect on high value-added jobs in other services sectors.

- Korea’s financial service sector contribution to GDP lags that of other global financial centers.
- Need an environment conducive to investment / job growth.
- Improve labor market flexibility in conjunction with conversion of contract workers to permanent workers.

Financial Sector as Engine of Growth

Role of Korean Banks

Comments on Advancing the Financial Industry
Comments on Advancement of Financial Industry

- Need predictable, transparent and consistent policies
- Market based principles should be adhered to
- Encourage inputs from market participants in rule making and evaluation of existing rules and regulations
- Change the regulatory paradigm (shift from “positive list system” to a “negative list system”)
- Minimize entry barriers caused by business licensing practice
- Relax regulations on offshore data processing for global firms
- Eliminate overlapping regulations in Business Delegation
Household Debt

- Supportive of the need for household debt resolution schemes
- Banks could positively consider more unsecured lending to near-subprime client segment (risk needs to priced properly)
- Temporary relaxation of Bank LTV ratios to refinance their clients’ high cost unsecured loans for primary residence
- Disallow PDRS filing within first 6 months from loan disbursement to prevent system abuse

Consumer Protection

- Transparency of pricing and proper explanation on product characteristics is key so customers can make informed choices
- Administrative burden without benefit to customers (form over substance)
- Any government examination or recommendation on prices (fees, interest rates) will run counter to principle of market economy
- How to strike the right balance between rights of consumers and banks?
- Level playing field (same regulatory framework for all financial institutions) is needed
Korea: Big Economy – Small Currency

- Korea’s Status in the World
  - GDP 11th largest
  - Trade > USD 1 trillion = 9th largest
  - FX Reserves > USD 317bn = 7th largest

- Current Assessment of the FX Market
  - Thin and narrow market relative to global FX market
  - Korea returned to “real demand principle” in 2010 (corporates can only hedge underlying proven exposures)
  - Banks subject to tight FX derivatives position caps
  - Still many restrictions for capital account and current account transactions
  - Emergence of a large offshore NDF market (world’s largest) due to onshore restrictions

- Korea has a low proportion of overseas investments (9.6% in 2010) compared to Japan (22%) and Canada (39%), partly due to “home bias”

- One directional FX market as a result of unbalanced capital flows
  - “one way bet”?
Korea remains classified as “Emerging Market” (MSCI EM Index) due to lack of full convertibility of KRW and lack of offshore KRW settlement ability
- EM investors tend to behave differently from Developed Markets investors
- Contributes to higher capital flow volatility

Where we are right now
- No clear road-map for development of FX Markets
- No plan for liberalization of FX regulations
- Korean Won is still not an international currency (offshore settlement not allowed)
- Korean Won only partially convertible (subject to many limits and restrictions)
Korea: Historic Review of FX Liberalization

- 1994: Foreign Exchange Reform Plan announced
- 1996: OECD membership
- Dec 1997: Free-Floating Exchange Rate system introduced
- May 1998: Ceiling on foreign investment in Korean equities abolished; bond markets open to foreign investment
- April 1999: Introduction of FX Transaction Act – Liberalization of current account transactions
- 1999: “Real Demand Principle” for FX Forward and Derivatives was abolished
- June 2005: “Overseas Investment Activation Plan”
- Nov 2007: MoFE announces “Measures to establish market friendly FX transaction system”
Oct 2008: Government announces to postpone indefinitely the 2nd stage of FX Liberalization Measures


- Return to the “real demand principle” for companies (hedging limited to 100% of underlying exposure)
- Companies can only borrow FX loans / issue FX bonds onshore only for purpose of overseas usage
- Cap on Banks’ FX Forward Position
- Strengthened FX Liquidity ratios for Korean banks (preventing currency and maturity mismatches)
- Re-introduction of Withholding Tax on interest and capital gains on Korean bond investments held by foreign investors (aimed at reducing excessive inflows of “hot money”)
- Bank Levy on offshore borrowings

Unintended Consequences:

- Build-up of a sizable offshore NDF Market in response to onshore restrictions
- Bank Levy impact on supply of trade finance

Policy measures proved effective as “stop gap” measures

FX restrictions may give illusion of absolute control over FX capital flows
Globalize Korea’s FX System

- Continue the FX liberalization path step by step
  - Remove remaining FX restrictions for inflows and outflows
  - Change all “prior reporting” items to BoK and MoSF into “post facto reports to FX Banks”

- Allow offshore settlement of Korean Won
  - This will support Korean importers and exporters by reducing exchange risks
  - Learn from the RMB experience

- Achieve Full Convertibility through full liberalization of the FX Market
- Pursue Internationalization of the Korean Won (= creating demand for Korean Won)
- Attain “Developed Market” Status in MSCI Index
- Use Macro-prudential measures to curb capital flows only on temporary basis, not permanent basis
- Eliminate onshore restrictions that have caused offshore NDF market rise
Risks and Benefits of KRW Globalization

**Risks**
- Foreign Currency hoarding in case of a crisis
- “Burnt” by previous crisis experiences in 1997 and 2008
- Speculative FX trading activity
- Increased capital flow volatility

**Benefits**
- Reduce exchange rate risk of enterprises
- Deepening of FX market
- Korea would be more resilient to external shocks
- Increase demand for KRW by residents and non-residents
- Koreans deserve to use their currency without restriction as they deem fit
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