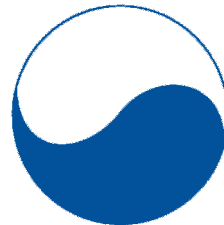

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CONTENTS

Part I: Overview and Macroeconomic Issues

Overview of the Korean Economy <i>Jeon Jong-kyu</i>	1
---	---

Part II: Financial Institutions and Markets

Korea and the IMF–World Bank Financial Sector Assessment Program <i>Meral Karasulu</i>	7
--	---

The Banking Sector <i>Thomas Byrne</i>	15
--	----

The Corporate Bond Market in Korea <i>Kim Sungmin</i>	20
---	----

Part III: Structural Reform

Public Sector Reform <i>Lee Kang-ho</i>	33
---	----

Business Perspective on Corporate Reform <i>Oh Moon-suk</i>	41
---	----

Accounting Reform <i>Lee Suk-jun</i>	48
--	----

Part IV: External Issues

U.S.-Korea Economic Relations View from Washington <i>Nan N. Fife</i>	55
View from Seoul <i>Lee Hyun-ju</i>	61

Korea-China Relations <i>Lee Chang-kyu</i>	69
--	----

Part V: North Korea's Economic Development and External Relations

Economic Reform in North Korea <i>Bernhard Seliger</i>	77
--	----

Japan-North Korea Relations <i>Mimura Mitsuhiro</i>	87
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THE KOREAN BANKING SYSTEM SIX YEARS AFTER THE CRISIS

by Thomas Byrne

Overview

The improvement in the credit ratings and financial strength of Korean banks reflects the overall positive developments in Korea's banking industry since the 1997 Asian financial crisis, including healthier fundamentals and continued internal restructuring. Consolidation in the banking industry has created very large banks. During the past several years, the Korean banks have removed a significant number of problem loans and benefited from sizable recapitalizations. The banks have also upgraded and improved systems and processes that have increased operational efficiency and enhanced operating conditions. Strong profit performance in 2000–02 allowed the banks to expand loan loss provisions and further bolster their capital cushions. However, the performance of the banking system faltered in 2003 because of credit losses arising from the household sector, a development that reflects the continued underlying fragility in the Korean financial system.

In the view of Moody's Financial Institutions and the Sovereign Risk Group, the Korean banking system has, nevertheless, improved to a stage where it is better positioned to withstand stress. In part, this is attributable to anticipated government support, if needed. The significant strengthening in the capacity of the Korean government to support the banking system is reflected in the relatively high A3 country ceiling for foreign currency deposits of Korean banks, a rating that is now in line with the sovereign foreign currency rating. At this level, Moody's historical default record (according to Moody's historical default rates) indicates a 1 percent to 3 percent probability of default over a five- to ten-year period.

On a stand-alone basis, however, Moody's view is that, although there has been some overall improvement since the crisis, Korean banks as a whole display modest intrinsic financial strength, potentially requiring outside support from the government or shareholders at times. See *Table 1*, which provides several countries' bank financial strength ratings

(BFSRs). Korea is rated D–; this is up from an average of E+ during the crisis. Although several of Korea's private banks have somewhat stronger ratings, in the D+ to D range, the system average is pulled down by the weaker E+ ratings assigned to the government-owned or intervened banks such as Korea Development Bank (KDB) and Woori Bank. It is such institutions that still figure prominently in government interventions in the financial system, the most recent case being the ongoing rescue of LG Card.

Table 1: Selected System Bank Financial Strength Ratings (BFSRs)

Country	Average BFSRs
Netherlands	B+
United States	B
Portugal	B–
Global average	C+
South Africa	C
Mexico	C–
Malaysia	D+
Brazil	D
Japan	D–
Korea	D–
China	E+
Argentina	E
Uruguay	E

Source: Moody's, end of 2003.

Note: A denotes superior; B, strong; C, adequate; D, modest; E, weak intrinsic financial strength.

Moody's ratings will continue to incorporate some margin for mild shock scenarios. Moody's notes that the Korean economy has had a tendency to undergo fairly rapid and pronounced cycles. The current cycle is being driven by the overextension of consumer credit, particularly credit card debt, which banks embraced in place of corporate loans after the crisis. The cyclical downturn has resulted in significant losses for those banks with substantial exposures, but not for every bank. On the whole, Moody's bank credit and financial-strength ratings at the moment look pretty secure on the basis of worst-case-scenario

stress tests. At this point, Moody's does not expect to adjust downward the bank ratings because of the credit card crisis. The banks are financially strong enough to absorb potential losses, and the industry appears to have bottomed out.

In the medium term, there are several structural issues confronting the banking industry. The reprivatization and sales of SeoulBank to Hana Bank and Chohung Bank to Shinhan Financial Group, while they closed the asset gap with Kookmin Bank, have led to the emergence of a tier of megabanks. Shareholding changes, which have drawn in new foreign investors, have taken place at numerous banks. Nonbank financial institutions such as credit card companies have been reabsorbed into parent banks. Policy banks are increasingly commercializing their businesses. Moving forward, banks have to grapple with integration and restructurizing issues. Although size is clearly an advantage, synergy benefits may well be negated by integration problems. As the industry landscape changes, Moody's thinks the banks will be forced to redefine their competitive positions.

Government Support Remains a Key Feature of the System

The government financial support of banks will likely continue—existing banks are too big and too few to fail. The removal of marginal and weak institutions from the system will concentrate future public resources, if necessary, on the remaining few. The government also remains highly supportive of the financial sector through the use of its regulatory powers, by which it can affect the operating environment. The government has played a prominent role in the rise and fall of the credit card sector and in its ongoing resolution. From a credit perspective, the strong support from the government is rating enhancing in the short term, but it could be a negative factor in the longer term in strengthening the banking system. Government support could postpone the introduction of a better incentive structure, one that would minimize future moral hazard risks.

The Cost of the 1997 Crisis

Since the financial crisis, the government has spent 161 trillion *won* to stabilize the financial sector and

recapitalize banks; 97 percent of the government support was injected between 1998 and 2001. Recovered public funds totaled 61 trillion *won* as of October 2003, a recovery rate of 38 percent so far. The government estimates that, at the end of the process, 69 trillion *won* will be unrecoverable. Of this, financial institutions are expected to shoulder 20 trillion *won*, which will be funded by a special deposit insurance fee. The government will fiscalize the remaining 49 trillion *won* of unrecoverable funds in its budgets between 2003 and 2027. Thus, the ultimate cost to taxpayers of the 1997 crisis and its aftershocks may be equal to about 9 percent of the gross domestic product (GDP) in 2003—if these estimates are on the mark.

Postcrisis Shocks Considerable, but Not as Severe

Following a period of postcrisis improvement, asset quality deteriorated during 2003. For the banking system, the nonperforming-loan (NPL) ratio inched up to 3.2 percent in June 2003 after falling to a postcrisis low of 2.3 percent at end 2002. This uptick reflected the banks' material exposure to SK Global, the decline in consumer credit, and, to a lesser extent, higher delinquencies in loans to small and medium-size enterprises (SMEs). In the case of SK Global, banks have provided about 60 percent against their exposures. The SK Global bankruptcy underscores the carried-over practices and limitations of precrisis corporate Korea. Bank vulnerability is, however, mitigated by banks' reduction in exposure to this sector—by June 2003, the top six banks had trimmed their corporate exposures to 12 percent of lending; this compares with 23 percent at the end of 2000.

In the past, Moody's expressed some doubt that, because of regulatory forbearances and lax internal guidelines, published figures adequately depict the true extent of asset quality. Moody's now thinks that published NPL figures have improved and are less understated, but that there is still room for more stringent asset classifications. In addition, Moody's maintains its view regarding corporate stress: the sector is still highly leveraged. Thus, the underlying potential credit losses on the loan books are high; this is due in large part to continuing high corporate leverage, excess industrial capacity, and high volatility in corporate

earnings. Rising household debt and credit card delinquency problems are expected to be more material contributors to Korean banks' NPLs over time.

The Household Debt and Credit Card Problem

The shift to consumer bank lending has contributed to the rapid rise in household debt, which has risen to around 70 percent of GDP in 2003—similar to the rate in the United States—from about 47 percent of GDP in 1997. Banks scaled back new lending to households in 2003, helping to arrest the growth of total household debt in the first half of 2003. Nevertheless, debt remains large for households, and maturities for most debt are relatively short, making borrowers vulnerable to economic shocks.

The contractionary effect on the economy in 2003 from retrenchment in household spending because of unsustainable leverage was seen in the cutback in real private consumption, which declined 2.2 percent in the second quarter (year-on-year) and 1.9 percent in the third quarter. As a result, Korea was one of the few Asian countries that did not participate in the East Asian macroeconomic recovery last year. Korea's GDP was only about 2 percent higher in the third quarter of 2003 than it was the same period a year earlier, indicating a considerable loss of momentum from annual growth of 6 percent in 2002.

The credit card delinquency problem arose just as the SK Global accounting scandal erupted, roiling the financial markets as credit card companies lost access to the bond market. Efforts to manage the problem included the government's plan to extend maturities for credit card company bonds. Credit card companies took self-help measures such as increasing capital and disposing of nonperforming assets. Delinquent assets peaked at almost 10 trillion *won* in May 2003 and declined in subsequent months, but they have remained stubbornly high, ticking back up close to 8 trillion *won* in November 2003.

The credit card problem has primarily affected the performance of credit card companies themselves, yet consumer credit losses practically erased a full year of profits of the banks in 2003. Mergers of banks with their credit card affiliates will add to their expo-

sure to the household sector. Also, banks have exposure to household credit card holders indirectly through their loans to and bond holdings of credit card companies. The headline case is LG Card, the bailout plan for which features the provision of approximately 2 trillion *won* in emergency collateral-based loans from creditor banks. The state-run KDB agreed to oversee the company's operations for one year (evidence of the need for continued government support of the financial system), although as of late January 2004 the 16 creditor banks had not yet put a restructuring plan into action.

Postcrisis Evolution of the Korean Banking System

The postcrisis evolution of the banking industry in Korea has featured consolidation and privatization, leaving 14 nationwide and regional commercial banks in the system, down from 26 before the crisis. Following the November 2001 Kookmin Bank–Housing & Commercial Bank merger, which created a bank with 30 percent of the deposits in the country, Hana Bank acquired SeoulBank in December 2002 to become the third largest bank, and Shinhan Financial Group acquired Chohung Bank in September 2003 to create the second largest financial group.

The banking sector consists of mammoth banks and small banks. The top four banks/financial groups control three-quarters of the market by most measures. Because of the dominance of the major banks, small banks may encounter difficulties competing on the basis of scale. In the longer term, this situation may fuel another round of mergers and acquisitions. Consolidation can create a more favorable operating environment and bottom line as pricing discipline is restored and if operational economies of scale can be achieved. For that to happen, integration risks, involving corporate culture and franchise definition, must be avoided.

Privatization has removed SeoulBank and Chohung Bank from the hands of the government. The formation of financial holding companies (FHC) stalled during 2002 and 2003, but several banks have reabsorbed or are planning to reabsorb their nonbank financial subsidiaries or sister companies. From a credit perspective, the impact of FHCs on bank ratings over

the medium term is neutral at best. For example, in the cases of two FHCs, Shinhan Financial Group and Woori Finance Holdings, the banks remain the groups' principal operating entities and are largely responsible for upstreaming dividends if the parent has a need for funds.

Restructuring and commercialization of the banking business was initially prompted by necessity—by the financial crisis—but it is now driven by the desire to elevate banks to international best-practices standards. However, most banks are likely to face major hurdles in striving to attain full commercial status and international competitive standards. Resources—finance, management, technology, and infrastructure—required to achieve these objectives will be huge. Moreover, something of a herd mentality still exists in the industry in Korea. For those that enter new businesses, the strategies carry greater potential risks because of the lack of experience. This is apparent in the current asset quality problems of the credit card industry that followed the industry's explosive growth during 2002 and 2003. Some banks will be able to tap foreign entities for expertise, experience, and management know-how. The common method of bringing in foreign talent has generally been via equity stakes by foreign investors. The approval by the Financial Supervisory Commission of Citigroup's application to acquire all the voting shares in Koram Bank seems likely to elevate competition in the banking system even though the new entity's assets will not rival those of the four largest banks in the system, which hold three-fourths of the system's assets.

As part of the commercialization process, banks have been diversifying their loan books by shifting out of corporate lending. They initially embarked on consumer banking, but, because of overstretched consumers, they are now focusing on SMEs. The loan mix of the six largest commercial banks in June 2003 comprised 49 percent household loans, 40 percent SME loans, and 12 percent corporate loans; this compares with 35 percent, 42 percent, and 23 percent, respectively, at end 2000. While consumer and SME exposures are more granular, the combined risks could still be high, as seen in the credit card delinquencies. Over the long term, Moody's expects the banks to reach fairly balanced loan portfolios in terms of borrower type.

Korean Banks Have More Resilient Balance Sheets Now

Postcrisis events—massive capital raisings, recapitalization from the government, and earnings—have replenished system risk-weighted capital to reach the 11 percent level. This level exceeds precrisis capital levels. In addition, the authorities have also helped by allowing banks to raise alternative sources of capital such as hybrid Tier 1, while the equity markets are showing brighter prospects for capital raising. For the six largest banks, Tier 1 capital was slightly more than 6 percent of risk-weighted assets. Although several banks have issued hybrid Tier 1 capital, the proportion of quasi equity is relatively small. On balance, the quality of capital is moderate. Regulatory pressure should induce an augmentation and improvement in quality of capital in banks.

Despite the deterioration in asset quality, Moody's stress tests show that recapitalization and earnings generation since the crisis have built sufficient buffer for banks to remain solvent given the current risks in the balance sheets and assuming the economic downturn is temporary. The stress tests indicate that all Korean banks in our universe remain solvent, assuming that (a) reported precautionary and below loans, net of provisions, are completely written off against capital (as long as banks have soundly classified problem loans); (b) normal loans receive a 1 percent provisioning; and (c) credit card receivables incur a 50 percent loss. Moody's expects the economic slowdown to be contained to 2003 earnings and not affect capital levels.

The Outlook

Although consumer credit losses in 2003 practically erased a full year of profits, 2004 may see resumption in earnings growth of banks if the consumer debt problem is contained and economic growth picks up. However, even during a normal profit cycle, returns generated by the sector have been low. A greater drive toward commercialization and profit-based lending will be needed to overcome the legacy of the past decade in which the banking system was unable to generate positive returns on average assets on a risk-adjusted basis.

Coming out of the crisis, the earnings trend of Korean banks has been volatile, marked by massive non-operating and nonrecurring items. Earnings growth has been strong, but the many one-off type items from clearing NPLs and restructuring costs distort year-on-year comparisons. If Korean banks could achieve and sustain consistency and stability in earnings, it would be ratings enhancing. We see the banks attaining an increasingly stable earnings trend over time, in line with the maturation of the financial system and the corporate sector.

In summary, Korean banks have the backing of ample public resources, and their financial fundamentals are improving. Consolidation, privatization, and commercialization are pluses, as is greater foreign participation in the system. Key risks include government intervention that impedes commercialization, the banks' herd mentality that limits franchise differentiation, integration and execution risks that become higher as banking institutions become larger in size, lingering exposure to a generally frail corporate sector, an over-extended household sector, and less accounting transparency versus international standards.

Mr. Byrne is with Moody's Financial Institutions and Sovereign Risk Group. This paper is primarily based on "Korea's Banking System Outlook, January 2004," authored by Moody's lead bank analyst for Korea, Beatrice Woo.



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