Korea's Economy 2005

a publication

of the

Korea Economic Institute

and the

Korea Institute of

International

Economic Policy

Volume 21

CONTENTS

FINANCIAL INSTITUTIONS AND MARKETS

POST-CRISIS TRANSFORMATION OF KOREA'S BANKING SYSTEM

by *Thomas Byrne*

Overview

Korea's banks have accomplished substantial restructuring since the 1997 financial crisis; the progress they have made is recognized in Moody's upgrading of most banks' underlying bank financial strength ratings (BFSRs). Credit ratings of the largest and most important Korean banks have been raised in line with the sovereign's rating, reflecting the availability of government support. Institutional and governance reforms have reduced moral-hazard risks, which figured prominently as a cause of the crisis and added to the cost of the crisis. Neither Moody's bank credit ratings nor its BFSRs were placed in jeopardy by the troubles within Korea's credit card industry; currently banks' direct exposure to problems in the credit card industry have been reduced to the low, single-digit range from as high as 10 percent for some banks. Moody's believes the small and medium-size enterprise (SME) sector is likely to pose even less of a threat to bank ratings, despite the banks' larger exposure to the SME sector.

The legacy of the 1997 crisis is still evident, however, in elevated public-sector debt levels, which are currently undergoing a direct fiscalization into the central government's budget and debt position. The impact of the use of public funds to bail out Korea's financial system has been to raise government debt by 15 percentage points of gross domestic product (GDP) after 1997. This is not a trivial amount, but the robust recovery in the Korean economy since the crisis has enabled the government to carry a larger debt burden without causing significant pressure on interest rates or on government finances.

Banking System

Korean banks have transformed themselves into more diversified, commercial institutions capable of competing in a more liberalized banking environment. More important, Korean banks are economically solvent (***Table 1***), albeit marginally in some cases. Highlights in 2004 include:

- Mended balance sheets, with regulatory capital above 12 percent (Bank for International Settlements [BIS] ratio);
- Manageable asset quality: the ratio of loans classified as substandard and below (SBL) is now 2 percent compared with 15 percent in 1999;
- Stronger profitability; and
- A transformation of internal systems and processes (for example, credit risk management and reporting transparency).

Table 1. **Soundness of Korea's Banks, 2001–2004**

Criteria	2001	2002	2003	2004
Net income (*won,* billions)	4,684	5,013	1,682	8,775
BIS ratio	11.7	11.3	11.2	12.1
SBL ratio	3.4	2.3	2.6	1.9

Source: Monthly Financial Statistics (Seoul: Financial Supervisory Service), http://english.fss.or.kr/en/englishIndex.jsp.

Another sea change since the 1997 crisis is that foreign participation appears to be a permanent feature of the Korean banking industry. The second and recent round of shareholding changes have kept foreign-owned domestic banks in foreign hands. A conceivable reversion to domestic ownership did not occur in the cases of Korea Exchange Bank, KorAm Bank, and Korea First Bank. These three majority-foreign-controlled banks now account for approximately 15 percent of Korea's total banking system assets (including policy banks), up from a negligible level before the crisis. In addition, ING owns about 4 percent of Korea's largest bank, Kookmin; and Allianz owns about 5 percent of the shares of Korea's third-largest bank, Hana (Singapore's Temasek owns almost 10 percent but is a passive shareholder). Although the Korean banking system is not as open as others (although limitations on foreign ownership of banks have been relaxed, foreign participation is less than in many countries), it is not nearly as protected a market as it was before the crisis.

Moody's expects that Citibank's entry into Korea's domestic market via the purchase of KorAm Bank will exert significant pressure on domestic banks. Citibank Korea's enlarged franchise will provide it with a credible-sized business, higher visibility, and greater market reach. KorAm Bank was the seventh-largest of the eight remaining nationwide commercial banks after the crisis, with a market share of 5 percent of system assets. Despite KorAm's relatively small size, Moody's does not underestimate Citibank's ability, stemming from its vast resources, to make a significant impact in consumer banking. Domestic banks with customer bases that overlapped KorAm's, such as Shinhan Bank and Hana Bank, could stand to lose market share.

Domestic banks have been adopting more commercial-based models since the crisis, but differentiation among banks is limited, especially among the larger banks that are similar in size and resources. A herd mentality dominates—banks first focused on credit cards, then on SMEs. While credit card problems and SK Networks were distractions in 2003, Citibank's entry will push the banks to fortify their market positions by transforming their franchises. Because franchise development on a commercial basis is relatively new to the Korean banks, however, Moody's would not be surprised if some rocky patches lay in the path ahead; one example is the SME market. Nevertheless, the credit card crisis may have helped banks in their learning process.

Basel II has created greater awareness of risk management and risk-adjusted returns. In the longer term, Moody's anticipates that Korea's banks will attain a more balanced loan portfolio and greater income diversification, which may help them reduce their susceptibility to big events typical of the Korean market and enable them to achieve a stable and consistent earnings trend that has been so elusive in the past. This factor would clearly be credit positive and create upward pressure on ratings.

Moody's holds the view that foreign involvement is, on balance, good for the banking industry and economy. Although foreign involvement may adversely affect some banks' market shares in the near term, it will promote global banking practices and raise standards over the long term. Furthermore, it will likely enhance management autonomy, as decisions should be driven by financial returns instead of government policy. For example, in the LG Card situation, some domestic banks run by foreigners chose not to participate in the resolution program. Their nonparticipation further reduces moral hazard, in which Korea's taxpayers and the country's fiscal position bear the risk of unsound lending practices. Finally, foreigners may provide the technical expertise as domestic banks diversify into other activities and become more sophisticated. Foreign participation should be a constructive influence on the banking system over the long term.

Finally, what implications could these changes have on our view about systemic support? Changes in franchise values are likely to influence BFSRs more than credit ratings. Moody's rating actions have captured these improvements—over the past two and a half years, BFSRs of eight Korean banks were raised. More recently, Moody's has raised the BFSR outlooks to positive from stable for four banks—Citibank Korea (formerly KorAm Bank), Hana Bank, Korea Exchange Bank, and Woori Bank. The BFSR was lowered in one case, but that was due to a specific corporate event. Excluding three of the public policy banks rated by Moody's, Moody's BFSRs for Korean banks range from D– to D+, indicating minimally adequate standalone strength. (The three policy banks have BFSRs of E+, indicating weak financial strength that may require government support.) Because the average BFSR of Korean banks is still well below Moody's global average of C+, the competitive challenge in the newly transformed Korean banking landscape may help to propel faster overall improvement in the underlying strength of the Korean banking system.

Moody's credit ratings already differentiate the level of support between locally owned domestic banks and foreign-owned domestic banks. For the latter, Moody's anticipates that the government will place greater reliance (or moral suasion) on the foreign shareholders to assume greater responsibility to support the banks. Moody's ratings for KorAm Bank and Korea First Bank have generally incorporated less systemic support. In conclusion, Moody's maintains this view and is likely to continue to distinguish support on the basis of shareholder domicile.

Potential Pressures from SMEs

In contrast with progress made by large listed companies in deleveraging, SMEs pose potential concerns for banks because of the underlying weakness of such firms. The reason for the concern is that banks are heavily exposed to SMEs—banks have made more loans to SMEs, more than one-third of outstandings, than to the *chaebol* or to households. Although the quality of SME loans appears on the surface to be manageable, with SBL ratio fluctuating around 2 percent, other data suggest that underlying financial conditions are rather weak in general. One-third of SMEs fail to generate enough operating income to cover interest expense.[1] This reflects the situation that, relative to *chaebol,* SMEs lag in restructuring progress and in productivity growth. However, firms in high-technology sectors have worse interest-payments-coverage ratios than firms in medium- and low-technology sectors. This has been due to interventionist government policy that fostered excessive investment in the information and communication technology sector.[2]

Systemic threats by the SMEs are, however, limited by a number of factors. Banks are far more experienced in lending to SMEs than they were in their knowledge of the credit card sector. SME loans are highly collateralized by real estate assets (more than 60 percent of total loan value), and the government has extended guarantees to the SME sector on the order of 6 percent of GDP, not a negligible amount for Korea and a large amount relative to other countries' practices. In a stress scenario, this would put some additional pressure on the budget and delay somewhat a reduction in government debt, but SME guarantees alone do not appear large enough to destabilize the government's fiscal position. Nor do SME guarantees threaten Korea's external payments position because of the absence of cross-border liabilities. In a stress-case scenario, the government and financial markets would likely respond with a greater tolerance for bankruptcy among such firms than they showed when they immediately supported some *chaebol* in the run-up to and in the wake of the 1997 financial crisis.

Lingering Effects of the Financial Crisis on Government Debt

While considerable progress has been made by banks in improving their balance sheets and by corporations in deleveraging seven years after the financial crisis, public-sector debt remains at an elevated level. Guarantees of about 107 trillion *won* issued by the government, mainly on Korea Deposit Insurance Corporation and Korea Asset Management Corporation debt (which bailed out the banking and nonbanking sectors), raised indirect, guaranteed government debt by about 15 percentage points of GDP between 1997 and 2001, pushing the level of direct and indirect government debt above 30 percent of GDP. (Bank of Korea intervention with the use of government bonds has also contributed to the rise in direct government debt during the past two years—to Moody's estimate of 25 percent of GDP in 2004, double the 1997 level.)

The immediate economic and budgetary effects of higher debt are not great. The market has absorbed whatever upward pressure increased government debt has put on the system, as interest rates remain at around historically low levels. In addition, central government expenditure on interest is only on the order of 1 percent of GDP. However, the increase in government debt lowers headroom for future contingencies, either economic or geopolitical. Economic contingencies may arise in the SME sector or in the nonbank financial institution sector, although the sale

---

1. "Republic of Korea—Concluding Statement of the 2004 Article IV Consultation Mission" (Washington, D.C.: International Monetary Fund, 28 October 2004), www.imf.org/external/np/ms/2004/102804a.htm.

2. Kim Joon-kyung, *Overview of Korean Corporate Restructuring since the Financial Crisis: Focusing on Profitability and Financial Soundness* (in Korean) (Seoul: Korea Development Institute, 26 June 2004).

of the troubled Hyundai Investment Trust Company (ITC) to Prudential Financial and the sale of Korea ITC to Dongwon Financial Holding Company signal meaningful progress in restructuring the financial sector at large.

Although the Korean government rightly points out that the government debt of 25–35 percent of GDP is much lower than the U.S. and EU average of 60–70 percent of GDP, major advanced economies with deeper capital markets and more credible fiscal policies can sustain higher levels of debt than other economies. The conclusion for Korea is that it should continue to limit contingent fiscal liabilities, make more progress in developing its regulatory systems and capital market, and sustain economic growth at its potential rate to recover fully from the effects of the financial crisis. A more competitive domestic banking sector is a step in this direction.

Mr. Byrne is with Moody's Financial Institutions and Sovereign Risk Group. The analysis of the banking sector recapitulates "Korean Banks—The Next Stage," Moody's Special Comment, *June 2004, authored by Moody's co-lead bank analyst for Korea, Beatrice Woo.*

KEI
Korea Economic Institute

Korea Economic Institute
1201 F Street, N.W., Suite 910
Washington, D.C. 20004