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The State Guarantee of External Debt of Korean Banks¹

*Lily S. Engbith*²

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Abstract

Following the Lehman Brothers bankruptcy of September 15, 2008, a number of foreign governments enacted stabilization measures in order to bolster their currencies and inject much-needed liquidity into domestic markets. As part of its effort, the Korean Ministry of Strategy and Finance announced a series of government interventions that included a three-year guarantee of foreign debt issued (including extensions of maturity) by domestic banks between October 20, 2008, and June 30, 2009. This opt-in program was introduced as a preemptive step in ensuring that Korean financial institutions would retain competitive access to external funding in the wake of the global credit crunch. Though the guarantee cap was set at \$100 billion, maximum utilization totaled only \$1.3 billion issued by a single participant (Hana Bank). On June 30, 2012, the guarantee scheme was terminated with the repayment of all obligations by Hana Bank.

Keywords: Korea, foreign debt, government guarantee

¹ This case study is part of the Yale Program on Financial Stability (YPFS) selection of New Bagehot Project modules considering the responses to the global financial crisis that pertain to bank debt guarantee programs.

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The State Guarantee of External Debt of Korean Banks

At a Glance

The collapse of Lehman Brothers in September of 2008 prompted many governments of developed economies to coordinate stabilization efforts in order to calm domestic and global markets. Among those, the Republic of Korea enacted on October 20, 2008, a series of measures that its Ministry of Strategy and Finance recommended would both aid in boosting the won against the dollar and help to relieve liquidity pressures stemming from the foreign currency loans coming to maturity in the midst of the worldwide credit crunch. This package included a \$100 billion, three-year government guarantee of foreign debt issued (including extensions of maturity) by domestic banks between October 20, 2008, and June 30, 2009. The opt-in program would allow participants access to guarantee coverage for up to 100% of principal and interest, including default interest and related expenses.

Summary of Key Terms	
Purpose:	To guarantee the foreign currency debt issued (including extensions of maturity) by domestic banks between the period of October 20, 2008, and June 30, 2009, in order to relieve liquidity strains stemming from those banks' difficulties in repaying their foreign currency loans.
Announcement Date	October 19, 2008
Operational Date	October 20, 2008
Date of First Guaranteed Loan Issuance	April 6, 2009
Issuance Window Expiration Date	Originally June 30, 2009; Extended to December 31, 2009
Program Size	\$100 billion
Usage	\$1.3 billion by Hana Bank in total
Outcomes	No defaults
Notable Features	Limited to debt issued in foreign currencies to ensure continued access to external funding

Eligible domestic banks needed to apply to the Ministry of Strategy and Finance to obtain foreign debt guarantees. Individual guarantee limits were set based on the Korean Financial Services Commission's assessment of each eligible bank's foreign debt maturing by June 30, 2009.

Only Hana Bank, one of Korea's four largest banks, applied to participate in the program, issuing a total of \$1.3 billion in guaranteed bonds in April and June of 2009. The State Guarantee program was terminated with the repayment of all commitments by Hana Bank on June 30, 2012.

Summary Evaluation

Given its limited utilization, few have evaluated the success of the guarantee program in isolation from other stabilization measures enacted at the time.

The State Guarantee of External Debt of Korean Banks: South Korea Context	
GDP (SAAR, Nominal GDP in LCU converted to USD)	\$1.2 trillion in 2007 \$1.0 trillion in 2008 <i>Source: Bloomberg</i>
GDP per capita (SAAR, Nominal GDP in LCU converted to USD)	\$24,086 per capita in 2007 \$21,350 per capita in 2008 <i>Source: Bloomberg</i>
Sovereign credit rating (5-year senior debt)	As of Q4, 2007: Fitch: AA Moody's: A2 S&P: A+ As of Q4, 2008: Fitch: AA Moody's: A2 S&P: A+ <i>Source: Bloomberg</i>
Size of banking system	\$1.1 trillion in total assets in 2007 \$1.1 trillion in total assets in 2008 <i>Source: Bloomberg</i>
Size of banking system as a percentage of GDP	94.2% in 2007 101.5% in 2008 <i>Source: Bloomberg</i>
Size of banking system as a percentage of financial system	Banking system assets equal to 100% of financial system <i>Source: World Bank Global Financial Development Database</i>

<p>5-bank concentration of banking system</p>	<p>79.3% of total banking assets in 2007 Data not available for 2008</p> <p><i>Source: World Bank Global Financial Development Database</i></p>
<p>Foreign involvement in banking system</p>	<p>12% of total banking assets in 2007 13% of total banking assets in 2008</p> <p><i>Source: World Bank Global Financial Development Database</i></p>
<p>Government ownership of banking system</p>	<p>Data not available for 2007 22.2% of bank assets owned by the state in 2008</p> <p><i>Source: World Bank Global Financial Development Database</i></p>
<p>Existence of deposit insurance</p>	<p>100% insurance on deposits up to \$44,792 in mid-September 2008</p> <p><i>Source: Financial Crisis: Deposit Insurance and Related Financial Safety Net Aspects, OECD</i></p>

I. Overview

Background

Having previously weathered the Asian Financial Crisis of 1997, the Republic of Korea was considered to have been relatively more prepared than its Western counterparts to manage the economic fallout from the Global Financial Crisis (Rhee 2008). However, the country was not completely immune to the deleterious effects of the subprime downturn in 2007; Korea in particular suffered major losses in the first half of 2008 as overseas investors collectively withdrew \$886 million and net foreign direct investment turned negative for the first time since 1980 (Fackler 2008). This divestment would later contribute to a deterioration in Korea's ability to repay its external debts. Consequently, despite efforts by the government to emphasize the economy's relatively stable domestic position, Korean markets remained vulnerable to exogenous shocks (Harden 2008).

Confidence dropped precipitously over the summer of 2008 as the stock market plummeted 38% and the Korean won fell 30% against the dollar (Harden 2008). In response, both banks and major corporations, such as Hyundai and Samsung, began hoarding domestic currency (Harden 2008, Sang-Hun 2008). To worsen matters, the September 15 Lehman Brothers bankruptcy sent global credit markets into turmoil and fueled further anxieties over the strength of Korea's export markets and foreign currency reserves (Fackler 2008). Domestic banks also began to bear the costs of the crisis more directly: Woori Bank, one of Korea's largest lenders, found itself unable to borrow after the collapse. Overseas banks refused to roll over many existing loans and insisted that Woori pay in dollars as the debt came to maturity (Fackler 2008). Dollar loans from the government totaling \$280 million kept the bank afloat.

This lending crisis spread quickly throughout the Korean financial system as it became increasingly clear that domestic banks would not be able to honor their maturing foreign currency loans. Following news of Lehman's insolvency, between 4Q2008 and 1Q2009, the banking sector suffered from rapid deleveraging as \$42.8 billion in assets were taken out of the country (Kim 2009). Such a large selloff, coupled with the depreciation of the won and rising borrowing costs, caused Moody's to declare Korea to be "one of the few banking systems in Asia where domestic deposits are insufficient to fund loans" (Eggertson and Krugman 2016, Sang-Hun 2008). Additionally, S&P downgraded the Big Four Korean banks—Kookmin Bank, Woori Bank, Shinhan Bank, and Hana Bank—from "stable" to "negative" on October 1. Their ability to raise foreign capital thus continued to decline (Gup 2010).

Having relatively recently opened its markets to the international community, Korea did not have access to the same emergency sources of foreign currency reserves as did other countries (Fackler 2008). At the same time, it was more susceptible to market instability due to its transparency and openness to foreign capital (Fackler 2008). The Korean government attempted to calm markets by pointing to the soundness of the domestic real economy, particularly in terms of its low sovereign debt levels and steady economic growth of 4.5% over the previous five years (Rhee 2008). Still, it was decided on October 19, 2008, that the government should follow its international counterparts in instituting tangible stabilization

measures. As part of the program, the government began to offer guarantees on inter-bank loans to mitigate the ongoing liquidity crisis, “calm markets and preemptively minimize the total cost of employing the intervention” at a later date (Rhee 2008).

Program Description

The State Guarantee of External Debt of Korean Banks (henceforth, the “State Guarantee”) would be operational from its announcement date of October 20, 2008, through June 30, 2009. The Operational Guidelines for National Guarantees of Foreign Debt Obligations of Domestic Banks (henceforth, “The Guidelines”), served as the memorandum of understanding between the government and the bank applying to issue debt under the guarantee program (2008). The “Proposed measures” document, a press release issued on October 19, 2008, by the Korean Ministry of Strategy and Finance, outlined the projected terms of the State Guarantee (Ministry of Strategy and Finance 2009).

Under the authority of Article 92 of the National Finance Act, the Enforcement Decree of the National Finance Act, and The Rules for the Management of State Guarantees, the Korean government introduced a foreign debt guarantee scheme as part of a comprehensive set of stabilization measures intended to alleviate market liquidity pressures and ensure that its domestic banks maintained a competitive advantage in overseas funding (Ministry of Strategy and Finance 2008). Together with the Bank of Korea, the government would provide the banking sector with an additional \$30 billion in dollar liquidity from foreign exchange reserves. Among other measures, it also provided tax incentives for the long-term holding of funds, invested Korean Won 1 trillion (ca. \$760.5 million³) in the Industrial Bank of Korea, and took concrete steps to strengthen regional and international ties. Recapitalization of financial institutions and the expansion of deposit guarantees were deemed unnecessary at the time (Ministry of Strategy and Finance 2008).

“We believe providing the government guarantee on banks’ foreign exchange dealings is the strongest step to save our foreign exchange reserves,” said Korean Finance Minister Kang Man-soo (Kim and Choonsik 2008).

Any debt denominated in foreign currency issued (including extensions of maturity) by a domestic Korean bank or its overseas branches during this period and owed to a “non-resident” institution (excluding foreign currency deposits and subordinated debt) would be eligible for a guarantee by the government for up to three years from the date of issuance or acquisition (The Guidelines). The government does not appear to have established minimum maturity requirements for eligible debt. On April 30, 2009, the guarantee was extended by the Ministry of Strategy and Finance to five years, although this allowance would prove to be unnecessary given the program’s limited utilization (Ministry of Strategy and Finance 2009a).

The Korean government needed to secure the approval of the National Assembly to fund the guarantee structure. In the interim, either the Korean Development Bank or Korea Eximbank

³ The October 20, 2008, exchange rate was 1 U.S. dollar = 1,315 Korean Won.

would provide guarantees. The Ministry of Strategy and Finance would then, after having received authorization, assume responsibility for all guarantees, including those previously offered by KDB or Korea Eximbank (“Proposed measures”). New debt would be guaranteed by the government only if explicitly requested and applied for (The Guidelines). The standardized guarantee (participation) fee, regardless of an individual bank’s credit rating, equaled 1% per annum of the daily outstanding balance of guaranteed debt on the basis of a 360-day calendar year (Ministry of Strategy and Finance 2009a). However, the Ministry of Strategy and Finance retained the right to set different guarantee fee rates “depending on market conditions, the financial condition of the Obligor, performance of covenants by an Obligor...and other relevant factors” (Ministry of Strategy and Finance 2009a). On February 16, 2009, the Korean government lowered the guarantee fee to 0.7% per annum (Ministry of Strategy and Finance 2009a).

The government imposed a \$100 billion cap on the total value of guarantees, as it was estimated that the external debt reaching maturity by the end of June 2009 would total \$80 billion (Ministry of Strategy and Finance 2008). There were also individual guarantee limits imposed on each bank. These were determined by the Financial Services Commission, which gathered information from the Financial Supervisory Services on the amount of each domestic bank’s foreign debt maturing by June 30, 2009, and added an extra 25% cushion (Jin-Woo 2008).

The guarantee agreement would be triggered by an event in which the “Obligor fails to satisfy its payments on a date due as required under the Guaranteed Debt” (Ministry of Strategy and Finance 2009a). Coverage would include 100% of principal and interest, as well as default interest and related expenses, accrued “until the date of actual payment by the guarantor, up to the Guaranteed Amount” (Ministry of Strategy and Finance 2009a). The government would also pay out in the event that the guaranteed debt were accelerated “as a result of the Obligor’s failure to comply with the covenants under the Guaranteed Debt” (Ministry of Strategy and Finance 2009a).

Outcomes

The Korean government issued only two bond guarantees to one of its eligible domestic banks over the course of the program’s duration. On April 6, 2009, Hana Bank issued \$1 billion worth of guaranteed bonds for a period of three years. Subsequently, it issued \$280 million for a period of either two and a half or three years. Hana Bank was ultimately able to meet all payments to foreign creditors without triggering the guarantee (Korea Institute of Finance 2009). All obligations, as specified by The Guidelines, were repaid to the lenders by June 30, 2012, at which point the program was terminated (Korea Institute of Finance 2009).

II. Key Design Decisions

1. The State Guarantee was announced as part of a package of proposed stabilization measures released by the Korean Ministry of Strategy and Finance on October 19, 2008.

Together with the Bank of Korea, the government would provide the banking sector with an additional \$30 billion in dollar liquidity from foreign exchange reserves. Among other measures, it also provided tax incentives for the long-term holding of funds, invested Korean Won 1 trillion in the Industrial Bank of Korea, and took concrete steps to strengthen regional and international ties. Recapitalization of financial institutions and the expansion of deposit guarantees were deemed unnecessary at the time

2. The Korean government implemented the State Guarantee using its authority under Article 92 of the National Finance Act, the Enforcement Decree of the National Finance Act, and The Rules for the Management of State Guarantees.

As discussed below, pending formal legal approval from the National Assembly, Korean authorities utilized the Korea Development Bank and Korea Eximbank to finance the State Guarantee.

3. The State Guarantee would be financed by Korea Development Bank or Korea Eximbank until approved by the National Assembly.

The Korea Development Bank and Korea Eximbank were charged with the responsibility of financing guarantees before the Ministry received formal approval from the National Assembly (Ministry of Strategy and Finance 2008). After gaining authorization, the Ministry would assume responsibility for all guarantees, including those previously offered by KDB or Eximbank (Ministry of Strategy and Finance 2008).

4. Up to \$100 billion in debt could be guaranteed under the program.

It was estimated that the external debt reaching maturity by the end of June 2009 would total \$80 billion (Ministry of Strategy and Finance 2008).

5. All domestic banks and foreign branches of those domestic banks were eligible for the State Guarantee.

According to Article 2 “Definitions” of The Guidelines, the term “Domestic Bank” refers to any one of the following: (i) Kookmin Bank, Shinhan Bank, Woori Bank, Hana Bank, Korea Exchange Bank, Citibank Korea, Standard Chartered First Bank Korea, Pusan Bank, Daegu Bank, Kwang Ju Bank, Kyongnam Bank, Jeonbuk Bank, and Jeju Bank, each established under the Banking Act; (ii) the Korea Development Bank established under the Korea Development Bank Act; (iii) Industrial Bank of Korea established under the Industrial Bank of Korea Act; (iv) the Export-Import Bank of Korea established under the Export-Import Bank of Korea Act; (v) National Agricultural Cooperative Federation established under the Agricultural Cooperatives Act; and (vi) National Federation of Fisheries Cooperatives established under

the Fisheries Cooperatives Act. “Domestic Bank” includes foreign branches of a Domestic Bank” (2008).

6. Initially, eligible debt included any debt denominated in foreign currency issued (including extensions of maturity) by a domestic Korean bank or its overseas branches during this period and owed to a “non-resident” institution (excluding foreign currency deposits and subordinated debt).

“Non-resident” as defined in Article 3, Paragraph 1, Subparagraph 13 of the “Foreign Exchange Transaction Act” (2008), excludes branches of foreign banks located in Korea by definition since the Act defines them as “residents.” However, Article 2, Paragraph 2 of The Guidelines (October 31, 2008) included them as “non-residents” (Ministry of Strategy and Finance 2008)

The “non-resident” definition part of Article 2, Paragraph 2 was deleted when the “Operational Guideline” was partially revised, as the purpose of the guarantee was thus changed from “State Guarantee of the Foreign Currency Debt of Domestic Banks owed to Non-Residents” to “State Guarantee of the Foreign Currency Debt.” This has the effect of extending eligibility to include foreign currency debt owed to “residents” as well as “non-residents.”

7. Initially, the State Guarantee would cover eligible debt for up to three years from the date of debt issuance or acquisition before this was later extended to five years.

The three-year period was later extended to five years, but all obligations were met by June 30, 2012. The government does not appear to have established minimum maturity requirements for eligible debt.

8. All foreign currencies were eligible.

Korean authorities limited eligibility to foreign currencies given their focus on ensuring institutions’ access to external funding.

9. There were individual guarantee limits imposed on each bank based on the amount of such bank’s foreign debt maturing by June 30, 2009.

These limits were determined by the Financial Services Commission, which gathered information from the Financial Supervisory Services on the amount of each domestic bank’s foreign debt maturing by June 30, 2009, and added an extra 25% cushion (Jin-Woo 2008).

10. Participating banks were required to pay a standardized guarantee (participation) fee of 1% per annum of guaranteed debt, subject to increase. The guarantee fee was later reduced to 0.7% per annum on February 16, 2009.

This standard fee, based off a 360-day calendar year, was imposed regardless of the individual bank’s credit rating. However, the Ministry of Strategy and Finance retained the right to set different guarantee fee rates “depending on market conditions, the financial

condition of the Obligor, performance of covenants by an Obligor [. . .] and other relevant factors” (Ministry of Strategy and Finance 2009a).

11. Participating banks were required to sign a Memorandum of Understanding (MOU) with the Financial Supervisory Services and report to them on a daily basis the usage of the guaranteed fund.

The MOU restricted the usage of the state-guaranteed funds to repayment of existing foreign currency debts.

12. The State Guarantee was designed to cover 100% of principal and accrued interest, including default interest and related expenses.

The Korean government would fulfill its guarantee obligations if the “Obligor [failed] to satisfy its payments on the due date as required under the Guaranteed Debt” (Ministry of Strategy and Finance 2009a). The Korean government would also honor the guarantee payments in the case that the debt under contract was to be “accelerated as a result of the Obligor’s failure to comply with covenants under the Guaranteed Debt” (Ministry of Strategy and Finance 2009a).

13. The issuance window was extended past its original date of June 30, 2009, to December 31, 2009.

This extension occurred despite limited utilization of the State Guarantee.

III. Evaluation

This intervention was employed as a temporary measure meant to calm domestic markets and preempt any assumptions that Korean banks were not as stable or competitive as their international counterparts (Ministry of Strategy and Finance 2008). It was also intended to boost the won and relieve liquidity pressures stemming from maturing foreign loans by shoring up confidence in domestic banks’ ability to lend (Ministry of Strategy and Finance 2008). Managing Director of the IMF Dominique Strauss-Kahn initially hailed the intervention as one that would “bring Korea’s policies closer in line with advanced countries, including some in the region, and help ease pressures in the local dollar funding market” (IMF 2008). Given the limited utilization of the guarantee program, few have evaluated its domestic impact or its role in the greater Global Financial Crisis.

Dongchul Cho, Professor at the KDI School of Public Policy and Management, concluded that implementing the series of stabilization measures “must have helped mitigate concerns of international investors” (2010). Furthermore, by the end of 2009, several domestic banks were able to access international capital markets without having to resort to the government guarantee scheme (Shabsingh 2013). Implementation of the entire stabilization package immediately boosted the won as much as 22% against the dollar (Harden 2008).

Conversely, Shenai argued that the “proximate effects of this intervention were clear: despite the announcement, the won continued to depreciate, and the stock market continued its skid. South Korea was not able to autonomously stem capital outflows” (2009). This situation was not unique to the won or Korean equity markets; many other emerging-market economies suffered similar depreciations in their local currencies and capital outflows. Shenai contends that the subsequent dollar liquidity swap agreement with the U.S. Federal Reserve was mainly responsible for calming markets (2009). Similarly, Hyekyung Cho argues in a report for the North-South Institute that although these “emergency measures temporarily stabilized the won, [they] did not help stop the massive capital outflow” (Cho 2012). These appraisals most likely reflected the strength of Korea’s domestic economy more than the actual success of the guarantee part of the government aid package, itself.

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Summary of Program

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