The Korean Financial Market and Economy: Resilience Amidst Turbulence

Chang Yong Rhee
My name is Chang Yong Rhee and I am the Vice Chairman of the Financial Services Commission of Korea.

I would first like to thank you for joining us in our IR presentation.

During the presentation, I plan to discuss Korea’s strong macro and financial position, then provide answers to some of the concerns that investors have raised over the Korean economy, and to explain the recent policy measures that the Korean government has implemented to address the current global financial market turmoil.
Strong Macroeconomic Performance
Korea’s economic performance has been very impressive, with a growth rate of 4.8% in the second quarter of this year.

This impressive growth was possible as a result to our strong export performance and a well diversified export portfolio even in the midst of an uncertain global financial environment.

Furthermore, as you are aware, Korea has maintained a sound fiscal stance and low sovereign debt levels. The fiscal surplus was recorded at 2.1%(estimated by S&P) of GDP in the first half of this year.

Such a sound fiscal position provides us with the maximum fiscal flexibility to effectively deal with a potential downturn in the global economy.
Improving Current Account Surplus

Although Korea has a well-diversified export portfolio and is a market leader across a number of industries, including semi-conductors, chemicals, and automobiles, the unexpected oil price surges this year forced us to record a temporary current account deficit.

Our current account balance recorded a deficit of $12.6 bn as of August largely due to sudden increase in crude oil prices. The cost of importing oil increased by $17.7 bn as of 2008. If we exclude the extra cost, the current account is in a surplus of around $5.1 bn.

However, we believe that the current account balance will recover to a surplus from 4Q and current account deficit is projected to be below 10 billion U.S. dollars this year.

We are also certain that the current account surplus will further increase in 2009.

I understand that some investors are concerned with the expected slowdown of Korean exports due to the global recession. But it should be noted that our imports will also be affected and more than anything else, our current account deficit is largely dependent on oil prices. For example, for this year, our oil import bill is expected to be about 80 billion U.S. dollars, and the fact that the oil price has declined by more than 30% implies that we can save 20 billion U.S. dollars next year from just the oil import bills alone.
As for the banking sector, Korean banks have shown an excellent record for the past few years in terms of asset quality, profitability, liquidity and capital adequacy.

The average NPL ratio of Korean banks’ has dropped to 0.7% in 2008 which is the historic low level. We have also maintained an average ROE ratio of around 15 ~ 20% and the BIS ratio has been very sound, marking 12% in 2007. This suggest that Korean banks are more than adequately capitalized to absorb any likely future loan losses.

These achievements in the banking sector have been possible through the lessons learnt from the crisis of 1997. After paying a high price for the tuition in 1997, the Korean government introduced one of the tightest banking regulations in the world and strictly enforced prudential rules to safeguard asset quality of banks.
Korea’s corporate sector has also improved remarkably over the past several years.

The earnings of listed companies improved greatly and, more than anything else, the corporate debt to equity ratio has decreased dramatically to 107% in 2007 from around 400% in 1998.

The financial conditions of small and medium enterprises have improved, too, and currently the default rate of corporate bills is about 0.03% in 1H08 from 0.08% in 2003.
Based on these strong macro performances, the new government has introduced bold visions and strategies for further developing the Korean financial markets and will try to create a more friendly financial environment for foreign and domestic investors through various reforms and measures.

We think that our efforts have been acknowledged by foreign investors so that the Korean stock market has recently achieved a developed market status by joining the FTSE index.
• Needless to say, despite the strong macro performance, Korean financial markets could not be immune from the global financial turmoil.

• In this section, I would like to address some of the concerns that foreign media and investors raised recently.
### Fact or Fiction?

#### Market Speculation

1. "Korea is at risk of external debt defaults."

2. "The Korean Banking System is too levered and faces a liquidity crisis."

3. "The Korean housing sector is under stress and may collapse."

#### Fact or Fiction?

- **FICTION**
  - A closer look at Korea’s external debt composition reveals that significant amount of external debt is risk-free
  - In addition, Korea has a healthy external sector with abundant foreign reserves and high liquidity

- **FICTION**
  - The banking sector has seen moderating loan growth in 2008 with continued low levels of delinquency
  - Furthermore, there is no foreign currency mismatch in Korean banks; foreign currency liquidity ratio remains high

- **FICTION**
  - The Korean Housing Sector has maintained balanced growth rates supported by robust mortgage regulations

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- In this slide, I have summarized the three main concerns that have been raised by the foreign media recently – which I consider a pure mischaracterization of facts.

- The first is about the level of external debt, that is, Korea has borrowed too much as was done in 1997 and even though Korea has large foreign reserves, they are illiquid to meet the short-term liability demands.

- The second criticism is that Korean banks are overleveraged and have problems with domestic and foreign currency liquidity.

- The third mischaracterization is that Korean banks could suffer from the sub-prime like crisis if housing prices in Korea start to decline in the future.

- Obviously, the Korea economy cannot be fully immune from the global economic downturn. However, let me assure you that the above characterizations of the Korea economy are absolutely unfounded and the government is fully able, with past experiences and vast resources to cope with the current challenges, probably more so than any other global peers.
I now wish to elaborate on the composition of Korea’s external debt.

As of the end of June 2008, the total external debt of Korea stood at $420 billion, of which 41%, 176 billion is short-term.

Out of this short-term debt, 10 billions are local currency denominated government bonds that foreign investors hold and 80 billions are debt that have been borrowed by domestic branches of foreign banks. After excluding them, only 86 billion is genuine foreign currency denominated short-term debts that Korean domestic banks and corporates have to pay.

Furthermore, if I breakdown the total debt by their nature, it is estimated that $152 billion out of 420 billion, or about one third, have virtually no risk. In other words, they are not subject to any repayment burdens in the future.

That is because 7 billions are pre-FDI funding, 93 billions have been incurred as a result of FX forwards hedging of pre-contracted future cash flows, and 50 billions are advance receipts for shipbuilding contracts. When we exclude this repayment-free debt, the genuine foreign debt of the Korean economy is only about $268 billion, and not the asserted $420 billion.
To address the issue of liquidity of our foreign reserves, as of September 2008, Korea had US$240 bn foreign reserves, which is the world’s 6th largest amount.

This amount far exceeds the IMF standards of a 3-month current account payment and is composed of highly liquid assets. Out of the total reserves, 90% are highly rated bonds, rated AA or higher.

As we suffered from “unusable” reserves in 1997, the Korea government has been extremely careful in FX management in order to prevent concerns by foreign investors regarding liquidity and the transparency of foreign reserves.

Therefore, I would like to assure you that our foreign reserves are fully liquid and they are valuable resources for us to sail through the current financial turmoil. To simply put it, 240 billion is enough for us to pay back all our short term debt and endure further significant foreign capital outflows in the worst-case scenario of prolonged turbulence in the global financial markets.
The next issue is the liquidity and solvency of Korean banks. Korean banks have recently encountered some difficulties securing overseas funding as a result of the global money market stress. On balance, we think Korean banks have been faring relatively well compared with others thanks to surplus funds accumulated from the first half of the year. Nonetheless, given recent policy initiatives of other governments to support their banks and a genuine risk of reverse–discrimination, the Korea government has recently decided to extend sovereign guarantees for foreign borrowing of Korean banks.

Some investors hold the misconception that Korean banks have significant currency and maturity mismatch problems as it had in 1997. But let me assure you that such a mismatch is very unlikely if not impossible, given the strict regulations on currency exposure and liquidity that we introduced after the 1997 crisis.

As you can see from the table on the left, Korean banks have no currency mismatch problem. It is true that Korean banks are trying hard to seek foreign funding at this moment. But the efforts are intended to maintain their foreign trade funding, rather than a reflection of a solvency problem.
Moreover, we remain confident about the asset quality of domestic financial institutions. Loan growth has been moderate in recent months, signaling improved risk management by banks, and most importantly, delinquency ratios remain at or near historical-lows, 1.5% in the case of SME loans and 0.6% in the case of household loans.

Our banks have a sufficient buffer to absorb loan losses. The average coverage ratio is about 186%. Given these statistics, as a regulator, I am very confident about the financial conditions of Korean banks.

Let me also assure you that the loan-to-deposit ratio of domestic banks is moderate at 103% as of September 2008, which is similar to the U.S. level, and far below 130% to that which has been cited by some foreign media. The misconception comes mostly from the exclusion of CDs.

In Korea, CDs have similar characteristics to deposits due to its high re-commitment rate. Moreover, more than 80% of CDs are sold to retail clients through over-the-counter bank teller sale. Therefore, it is reasonable to include CDs in calculating loan-to-deposit ratios and I believe it is an internationally accepted norm.
Robust Real Estate Sector

Historically, Korean real estate prices have lagged GDP growth, especially when compared to other markets. This balanced growth has been supported by prudent housing and mortgage ratios.

Balanced Real Estate Price Growth

<table>
<thead>
<tr>
<th>Year</th>
<th>Korea</th>
<th>USA</th>
<th>UK</th>
<th>Ireland</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>80</td>
<td>200</td>
<td>100</td>
<td>150</td>
</tr>
<tr>
<td>2001</td>
<td>100</td>
<td>220</td>
<td>120</td>
<td>160</td>
</tr>
<tr>
<td>2002</td>
<td>120</td>
<td>230</td>
<td>140</td>
<td>170</td>
</tr>
<tr>
<td>2003</td>
<td>140</td>
<td>240</td>
<td>160</td>
<td>180</td>
</tr>
<tr>
<td>2004</td>
<td>160</td>
<td>250</td>
<td>180</td>
<td>190</td>
</tr>
<tr>
<td>2005</td>
<td>180</td>
<td>260</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>2006</td>
<td>200</td>
<td>270</td>
<td>220</td>
<td>210</td>
</tr>
<tr>
<td>2007</td>
<td>220</td>
<td>280</td>
<td>240</td>
<td>220</td>
</tr>
<tr>
<td>2008</td>
<td>240</td>
<td>290</td>
<td>260</td>
<td>230</td>
</tr>
</tbody>
</table>

Improving Mortgage Loan-to-Value Ratio

<table>
<thead>
<tr>
<th>Year</th>
<th>LTV ratio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>52.2</td>
</tr>
<tr>
<td>2006</td>
<td>49.5</td>
</tr>
<tr>
<td>2007</td>
<td>47.9</td>
</tr>
<tr>
<td>2008</td>
<td>47.5</td>
</tr>
</tbody>
</table>

Stable Housing Price Changes

<table>
<thead>
<tr>
<th>Year</th>
<th>Korea</th>
<th>USA</th>
<th>UK</th>
<th>Ireland</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001-2007</td>
<td>6.7</td>
<td>9.4</td>
<td>12.6</td>
<td>9.7</td>
</tr>
<tr>
<td>2008 YTD</td>
<td>5.8</td>
<td>8.7</td>
<td>-16.4</td>
<td>-9.1</td>
</tr>
</tbody>
</table>

More Stringent Mortgage Regulations than Others

<table>
<thead>
<tr>
<th>Country</th>
<th>Mortgage/GDP</th>
<th>Regulation System</th>
<th>LTV Limit</th>
<th>DTI Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Korea</td>
<td>33.4%</td>
<td>Direct</td>
<td>40-60%</td>
<td>40%</td>
</tr>
<tr>
<td>USA</td>
<td>72.3%</td>
<td>Indirect</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>37.3%</td>
<td>Direct</td>
<td>60-70%</td>
<td>None</td>
</tr>
<tr>
<td>Germany</td>
<td>52.4%</td>
<td>Direct</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Japan</td>
<td>36.2%</td>
<td>Indirect</td>
<td>60%</td>
<td>None</td>
</tr>
</tbody>
</table>

- Is there a chance that Korea could suffer from a mortgage crisis if housing prices start to decline in the near future? I am confident that Korea will be probably the last country to suffer from it, thanks to our strictest regulations. In order to curb housing market overheating, the Korean government introduced mandatory loan-to-value ratios for mortgage loans in 2003 and debt-to-income ratios in 2005. Unlike advanced countries, Korean borrowers are unable to borrow more than 40–60% of housing values and they have been subject to strict income adequacy tests. These regulations are one of the strictest in the world, and I thank my predecessors for imposing those rules to safeguard our financial sector.

- Still, some might be concerned about the risk of a very dramatic drop in housing prices. But as you can see from charts on the left, the nation-wide housing prices have been relatively stable compared to those of other countries. It has been observed that countries now suffering from distressed mortgage loans saw their housing price jump two to three times during the last decade. But, during the same period, housing price rose about 65% in Korea. So, the likelihood of a sharp drop in housing price is quite low.

- Moreover, after the introduction of the LTV regulation in 2003, housing prices steadily increased till last year. Therefore, the actual loan-to-value ratios are lower than reported and I believe that this gives us enough cushion to cover future price declines, in contrast to most other countries that are suffering from a mortgage crisis.
The Korean Government's Response

• The Korean government fully recognizes that the world economy is in extraordinary times. As a result, we have taken a number of bold, decisive and pre-emptive steps to limit the effects of the global financial turmoil on the Korean economy.
Addressing Key Areas of Concern

To date, there has been minimal damage realized as a result of market turbulence. However, the Korean government has been highly preemptive in identifying and addressing potential risks.

1. PF Lending and Savings Banks
- The Financial Authority will monitor banks thoroughly to ensure that they comply with enhanced requirements, including the 30% Rule and reserve accumulation.
- Structure a system which incentivizes banks to restructure.

2. SME Lending
- SME liquidity support measures announced on October 1st.
- Run fast-track program until June 2009.
- Support liquidity through debt maturity extension, minimal interest burden, and debt/equity swap incurred from KIKO into lending.

3. Household Lending
- Measures to support household sector announced on October 21st.
- Extend redemption maturity of conditional lending.
- Accelerated deregulation of the housing sector.
- Support credit recovery fund for ones with poor credit ratings.

4. Construction Sector
- Support measures for Construction sector announced on October 1st.
- Promotion and support of private real estate fund to purchase unsold houses.
- Mortgage expansion for new housing inventory.
- Financial support to construction companies.
- Government purchase of land held by homebuilders.

- Given the risk of global contagion, the Korean government has recently been extra vigilant in identifying major areas of potential weakness and proactively implementing safeguarding measures.
- First of all, the government has taken steps to improve financial conditions of small mutual savings banks through enhanced supervision and coordination of M&As.
- For SMEs, we will focus our efforts on limiting risky exposure of banks to SMEs loans without aggravating SMEs’ liquidity problems. For that purpose, the government and the Bank of Korea are working closely together to relieve liquidity shortages through maturity extensions and credit guarantees for potentially profitable SMEs.
- With regards to household lending, most are housing related loans with very low LTVs and hence are unlikely to significantly damage the balance sheet of banks’. Nonetheless, we are trying to prevent a sudden cutback in household lending as it might have a negative impact on private consumption and business cycles.
- Lastly, we have recently announced a support package of 8 trillion Korean Won for the construction sector. It includes buy-back programs for unsold apartments from developers, CBO schemes for construction companies’ securities, and credit guarantee programs for real estate funds, etc.
Korea’s Stabilization Package (Oct 19th)
A comprehensive package to stabilize the financial system

The government will take decisive action to minimize downside risks to the economy.

- 3 year guarantees of FX debt issuance up to US$ 100bn
- Additional dollar liquidity equivalent to US$ 30bn to the banking sector by utilizing foreign exchange reserves
- Provisions to support Won liquidity
- Foreign exchange stabilization smoothing operation
- Tax incentives for long-term holdings of funds
- Undertaking for potential recapitalization of financial institutions and deposit guarantees, if necessary
- Expand bilateral currency swap schemes to G20
- Capital Injection of KRW 1tn into Industrial Bank of Korea, translating into additional loans worth KRW 12tn available to SMEs

On October 19th, the Korean government unveiled a comprehensive plan designed to prevent reverse-discrimination of Korean banks in international financial markets and to provide additional liquidity to the FX markets in Korea.

The package consists of 8 key measures. The cornerstone of the plan is to provide 3-year government guarantees for new foreign exchange borrowings by banks through to June 2009. This demonstrates the government’s confidence in the financial conditions of our Korean banks and a firm commitment to support our banks amid extraordinary turbulence in the international financial markets.

In addition, we have decided to provide an additional 30 billion dollars to banks to ease pressures in the FX market. Other measures include the capital injection of KRW1 trillion to IBK to promote SME lending and granting tax incentives for long-term holdings of equity and bond funds.

We believe that these measures will contribute to reduce reverse-discrimination of Korean banks, help stabilize the markets, and restore investor confidence.
Comparison with Asian Financial Crisis

Korea’s financial condition has improved vastly over the past ten years and the country is well-prepared to manage the current crisis.

<table>
<thead>
<tr>
<th>Causes</th>
<th>Asian Financial Crisis (late 1997)</th>
<th>Current</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal factors such as corporate bankruptcy</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign Currency Reserves</td>
<td>US$ 8.9bn</td>
<td>US$ 239.7bn (^1)</td>
</tr>
<tr>
<td>ST External Debt / FX Reserves</td>
<td>717%</td>
<td>68% (^2)</td>
</tr>
<tr>
<td>Liquid External Debt / FX Reserves</td>
<td>973%</td>
<td>86% (^2)</td>
</tr>
<tr>
<td>Total External Debt / FX Reserves</td>
<td>1,957%</td>
<td>173% (^2)</td>
</tr>
<tr>
<td>External factors</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank NPL Ratio</td>
<td>6.0%</td>
<td>0.6% (^3)</td>
</tr>
<tr>
<td>BIS Ratio</td>
<td>7.0%</td>
<td>12.0% (^4)</td>
</tr>
<tr>
<td>Corporate Debt Ratio</td>
<td>424.6%</td>
<td>106.5% (^4)</td>
</tr>
<tr>
<td>Corporate Interest Coverage Ratio</td>
<td>115.0%</td>
<td>404.8% (^4)</td>
</tr>
</tbody>
</table>

\(^1\) as of September 2008
\(^2\) as of June 2008
\(^3\) as of March 2008
\(^4\) as of end of 2007

- I would like to wrap up this presentation by presenting a few facts on how the Korean economy has improved following the Asian Financial Crisis in 1997.

- Yes, the current situation is quite different from 1997 and the comparison to the crisis of 1997 might be irrelevant in coping with the current difficulties. However, I hope that the remarkable progress we have made will help convince you that the Korea economy and the government has, through their experiences, are well-equipped and fully prepared in terms of both financial and human resources to manage the current international financial turmoil.

- The most telling difference is that the 1997 crisis was a result of our own internal weakness of corporate insolvency while the current turbulence originates from outside the region. Balance sheets of our corporations, banks, and the government are strong enough to overcome the challenges.
Thank you very much for your attention and let me close my presentation by promising to you that Korea has not disappointed foreign investors even in the difficult times in 1997, and will not do it either in the future.

Thank you again and we can move onto the Q&A session.