Observations on Current Financial Policy Issues in Korean Banking Industry

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Agenda

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- **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

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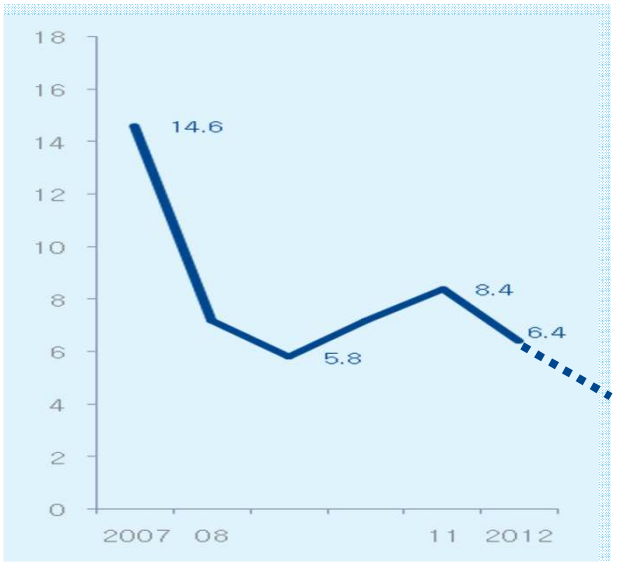
Return on Equity – Korean Banks



2011 ROE comparison by region

Latin America	Asia*	Korea	Other developed	US	Europe
19	17	8.9	10	7	0

* Asia : Without Japan and Australia

Net Interest Margin (NIM)

2004	2005	2006	2007	2008	2009	2010	2011	2012 Q3
2.59	2.81	2.61	2.44	2.3	1.98	2.32	2.3	**2.06**

Return on Assets (RoA)

(Unit : %)

2004	2005	2006	2007	2008	2009	2010	2011	2012 Q3
0.85	1.27	1.13	1.10	0.48	0.40	0.54	0.66	**0.43**

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

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- **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

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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

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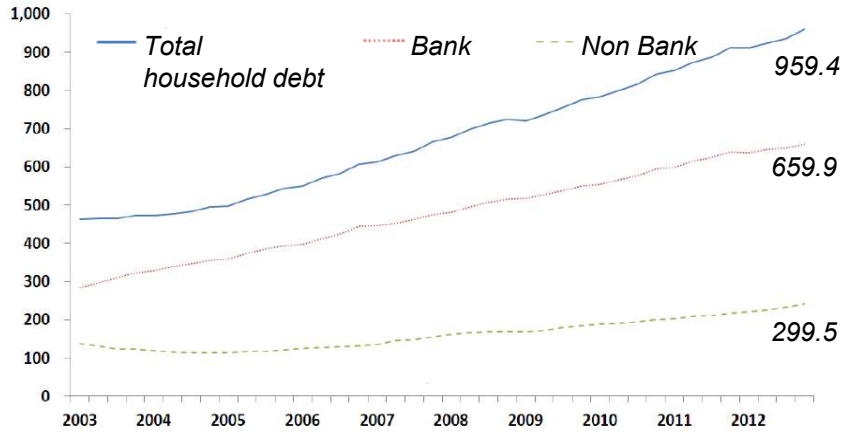
Cost of Debt is an increasing concern

Household Debt Trend

(Unit : KRW Trillion)



* Source : BoK

Average Lending Late and loan balance

FI		Mort.	Non Mort.
Bank	2012	4.63%	7.43%
Non Bank (2012)	Capital	5.4~10 %	24~26%
	Savings Banks	9~11%	28~29%
	Credit card	N/A	20-25%
	Money lenders	N/A	39%

FI		Outstanding
Bank		467.3
Non Bank (As of 2012)	Savings Banks	8.9
	NCUF	21.0
	Mutual Finance	124.0
	KFCC	37.2
	Insurance	79.6
	Pension	9.8
	Credit finance	39.6
	Other	172.0
Total		959.4

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

Observations on Household Debt (cont'd)

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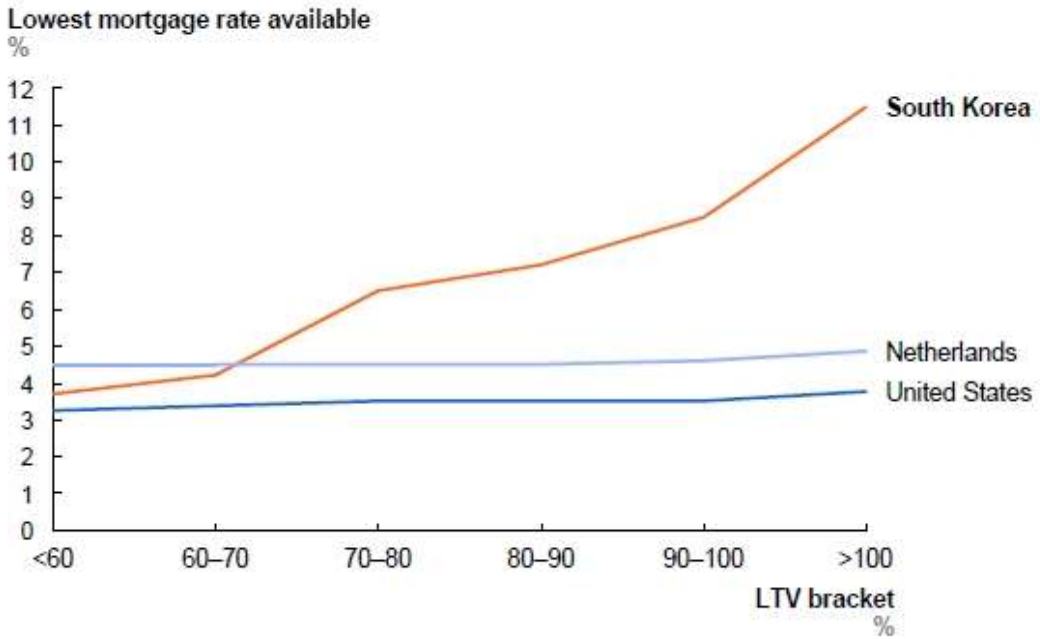
Unintended consequences of tight LTV rules

Exhibit 28

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

2012



SOURCE: Mistermoney.nl; bankrate.com; NICE report; expert interview; McKinsey Global Institute analysis

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)

Comments on Advancing the Financial Industry

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Financial Sector as Engine of Growth

- 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

Role of Korean Banks

- 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

Comments on Advancement of Financial Industry

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Address Key Concerns of Foreign Investors

- 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

Comments (cont'd)

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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

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- **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: Big Economy – Small Currency

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- 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

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- 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
- 2002: “Plan for Development of Korean FX Market” announced – full liberalization of FX regulations by 2011
- June 2005: “Overseas Investment Activation Plan”
- May 2006: Accelerated “Foreign Exchange Liberalization Plan” in 2 phases, targeting internationalization of KRW and full liberalization of FX transactions by 2009 (instead of 2011)
- Nov 2007: MoFE announces “Measures to establish market friendly FX transaction system”

FX Policy Measures since 2008 Crisis

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- Oct 2008: Government announces to postpone indefinitely the 2nd stage of FX Liberalization Measures
- Jan 2010 – 2012: Introduction of Macro-Prudential measures aimed at reducing 'speculative' inflows and outflows of foreign exchange
  - 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

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- 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

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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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