Excessive Loan Competition Worrisome

By Peter Tebbutt
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Korea's banks have made substantial progress since the 1997-1998 Asian crisis. Most notably, they have become more commercial as reflected by their seismic shift from large corporate lending to small-to-medium-size enterprises (SMEs) and consumers.

At the same time, there has been much development of the requisite risk management systems for such lending, as well as a substantial (albeit not yet complete) removal of government interference in the banks' operations. That said, the road has not been easy — just note the 2003 credit card crisis — and may not be all smooth sailing going forward.

A quick look at the makeup of the banks' loan books is instructive.

Korean Banks, Mid-06 Loan Book Composition and Growth Over 18 Months to Mid-06

	% of Total	Growth, 18M to mid-06
Large corporates	23	27
Small to medium sized enterprises (SMEs)	37	16
Mortgage loans	23	18
Other consumer loans	14	17
Credit cards	3	-12
Total	100	18

Source: FSS, Banks, Fitch calculations and estimates.

Compared to the table above, back in 1997, before the crisis, large corporates probably accounted for around 70 percent of banks' total loans, with SMEs accounting for most of the balance. The more diversified nature of SME and consumer lending — as well as its more collateralized nature — has substantially reduced risk (notwithstanding that Korean SMEs do tend to be quite large and often lent to on an unsecured basis). This is particularly so given that the expansion into SME and consumer lending has been accompanied by the development of the necessary risk management systems required to do such lending — as evidenced by the fact the Korea's banks will, in early-2008, become one of the earlier adopters of the new "Basel II" capital adequacy regime.

In terms of financials, the banks are quite healthy, as reflected in their A+ to BBB+ ratings. Core profitability has been quite good over recent years thanks to margins improving to a quite good level, and very low credit costs.

Net profitability has been particularly good with the banks benefiting from various one-off-gains — mostly the reversal of earlier-booked loan losses as

Peter Tebbutt

well as gains on equity holdings acquired through debt-for-equity swaps on other formerly problematic loans.

Meanwhile, with little in the way of new non-performing loans (NPLs) having been incurred since end-2004, loan quality is now excellent; at mid-2006, system-wide NPLs stood at only 1.1 percent of total loans, and were mostly well secured and/or reserved-for.

Securities investments were mostly low in terms of both credit and interest rate risks, although market risks remain notable at a handful of banks due to their remaining debt-for-equity swap securities holdings. Finally, efficiency at the banks is also good.

Perhaps the only area of disappointment in regards to Korea's banks is the relatively undeveloped nature of their fee generating businesses such as in the areas of wealth management and bancassurance products for consumers, as well as cash management and other treasury services for businesses.

To some degree, this reflects a heretofore lack of demand for such products and services, compounded by the considerable investment required to properly develop them. As both Korea's middle-class and businesses develop, however, opportunities for such products are growing and there is clear evidence the banks are investing in them. Notably, the foreign banks of Citibank and Standard Chartered First may well be particularly advantaged here, being able to leverage off the resources and experience of their global parents.

The development of such businesses, however, will be important for all banks given that competitive pressures are likely to drive margins lower going forward. Indeed, an aggressive grab for loan market share by certain banks over 2005 and in the first half of 2006 has already resulted in some compression of margins. The other banks may well follow suit and drive them down further.

Notably, any excessive competition for loans may well be more worrisome in terms of loan quality. The last time Korea's banks grew loans excessively was back in 2002 in the area of credit/cash cards — markets that they clearly did not understand — resulting in the credit card crisis of 2003.

While another credit card crisis is unlikely at this stage, Fitch would be concerned if the banks were to aggressively expand in any particular areas going forward, especially the SME and housing markets.

Large corporates, meanwhile, would appear to be the safest bet, given their strong sales since the 1997 crisis (both locally and abroad) and concurrent cleaning up of their balance sheets — leaving them well positioned to withstand any reduction in demand for their product — from US consumers for example.

SMEs, however, which are often dependent on just a few large Korean corporates for sales, and which have borrowed much from the banks since the crisis, may not be so well placed in the event that their large Korean corporate customers cut back on supplies and/or suppliers.

Meanwhile, the sharp run-up in some Korean home prices over recent years raises concerns about the banks' residential mortgage and home-equity loans. Such lending has also been quite strong over recent years and this may well continue as the banks endeavor to take advantage of the lower risk-weighting attached to mortgage lending under Basel II.

Problems in either the SME or housing sectors — let alone both — could in turn result in problems for the banks' unsecured consumer loans which have also at times been growing quite strongly over recent years, with credit card growth likely to be positive over 2006.

That said, while the banks have at times grown quite strongly in this sector or that over recent years, overall growth has generally been quite limited and well-diversified with no one sector having been excessively lent to yet.

Indeed, there have been times when the banks have pulled back from certain sectors when it appeared that enthusiasm was getting the better of them — e.g. SMEs in 2004 – reflecting a more mature, disciplined lending approach. Assuming this continues, the banks should be well placed to continue developing their businesses and perhaps even expand abroad over the years to come.

Korea Growing Into Tech Power House

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South Korea continues to be classified by international agencies, investment banks, and the financial press as an "emerging economy." The data indicate, however, that the country has joined the club of the richest and most advanced countries in the world.

With per capita gross national income approaching $20,000, South Koreans have attained a comfortable standard of living, ranking much higher than any Latin American country and most of South and East Asia.

South Korean gross domestic product (GDP), while expanding steadily, is no longer growing at the maverick rates characteristic of emerging economies. Not only are China, India, Singapore, Indonesia and Malaysia posting higher growth rates, but also Pakistan, the Philippines, Argentina, Colombia, Peru, Turkey, Russia and the Baltic republics seem to be performing better than South Korea.

There are both macroeconomic and microeconomic reasons to believe that the South Korean economy is on route to steady economic growth and an increasing standard of living for its population. What is, then, allowing South Korea to become richer every year and yet sustain relatively high growth rates?

The answers are to be found at the microeconomic level. Productivity growth, which is the key to long-term economic performance, continues to be strong. The country is excelling at creating knowledge and technology, and Korean brands have become household names around the world. Let me examine these three fundamental strengths in turn.

Labor productivity is fundamental to long-term economic performance because it helps keep inflation low and export competitiveness high. During the 1960s and 70s, observers pointed out that Korea's economic model would run out of steam given its emphasis on increasing factor inputs.

In a famous article titled, "The Myth of East Asia's Miracle," economist and columnist Paul Krugman argued as late as 1994 that the tiger economies of East Asia, including South Korea, were doomed because of their relatively low productivity growth. Krugman and the

Mauro F. Guillen

other pundits were wrong.

The South Korean economy has transformed itself from being a gigantic, though inefficient, manufacturing machine to one based on leaner organizational and managerial principles. South Korea's economic future seems assured if the country continues to improve labor productivity at its present pace.

One of the main reasons why labor productivity is growing so fast has to do with investments in knowledge and human capital. The South Korean population is among the most highly educated in the world. Although the way students are evaluated at the primary, secondary and university levels is biased in favor of certain subjects and ways of learning that tend to undermine creativity, Korean graduates are among the best prepared in the world in reading, science and mathematics.

Most importantly, South Korea is making a strong effort in the area of research and development, spending about 2.6 percent of GDP, compared to an average of 2.2 for the OECD. The country boasts some 156,000 researchers, ranking just behind the United States, Japan, Germany, France, and the United Kingdom (which has about 158,000).

Moreover, South Korean companies contribute more to the country's R&D effort relative to the government when compared to other countries. Korean residents are applying for increasing numbers of patents. With more than 40,000 patents granted by the U.S. Patent and Trademark Office, South Korea ranks 7th in the world in terms of the size of its stock of proprietary technology.

The only worrisome aspect on the technological front is the fact that South Korea suffers from a persistent trade deficit in technology, the largest of any OECD country at 2.4 billion dollars.

This shortfall is due to the fact that South Korean exporters of electronics, automobiles and machinery rely on foreign technology, which they must pay for. South Korea's traditional weakness has been not so much in the assembly stage of electronics, automobile or machinery production, but in the manufacturing of parts and components.

The success of Korean brands in global markets is the third unequivocal sign that the country's economy has come of age. Three Korean brands are presently ranked among the 100 most valuable in the world: Samsung (20th), Hyundai (75th), and LG (94th).

Only four other countries have more brands on the list, namely, the United States, France, Germany and Japan. China, in spite of the recent global successes of Haier and Lenovo, has none. It should not be surprising that it is Korean brands in electronics and automobiles that have become most visible around the world.

Those happen to be two of the country's most competitive industries, and consumers around the world have come to see their products not only as affordable but also reliable and differentiated.

South Korea's success in the areas of productivity, technology and branding clearly indicate that it has graduated from the world of the emerging economies. The country has become a rightful member of the OECD, the club of the most successful and advanced economies. Some observers might argue that the easy part has been done. South Korea was a very poor country two generations ago.

The parents and grandparents of today's working-age generation turned what once was a backward agricultural economy into a manufacturing powerhouse. Over the last twenty years, Korea has stunned the world with its technological development.

I see many reasons to be optimistic about the future. The only aspect to continue watching is whether the service sector manages to stage a revolution as far-reaching as the one experienced by manufacturing. South Korea deserves much credit for transforming itself from being one of the most dynamic emerging economies to one of the most technologically advanced.