South Korean government tries to shore up fragile banking system

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16 May 2012

South Korean authorities have been forced to move against more of the country's savings banks, fearing further collapses and renewed financial instability. On May 6, the Korean Financial Services Commission imposed six-month suspensions on the operations of four banks—Solomon Savings Bank, Korea Savings Bank, Mirae Savings Bank and Hanju Savings Bank—as part of an investigation into the country's secondary financial institutions.

The savings banks were suspended after it was discovered that they had a Bank of International Settlements (BIS) ratio under 5 percent. The BIS ratio indicates the solvency of a bank, showing the ratio between risk-bearing capital and risk-weighted assets. Banks are generally required to have a BIS ratio of around 8 to 10 percent. Of the four suspended banks, Solomon Saving Bank had the highest ratio at 4.35 percent, while Hanju Savings Bank had the lowest, at negative 37.32 percent.

Korean savings banks have been under close scrutiny since the largest of the banks, Busan Savings Bank, was suspended in February 2011. Busan officials have since been convicted of unlawful practices, including giving out illegal loans totalling 4.59 trillion won ($US4 billion) to companies owned by its chairman, Park Yeon-ho, and other majority shareholders.

The latest four suspended banks had been under investigation since last September. Corruption, including illegal lending, embezzlement and bribery, is alleged to have occurred. On May 7, prosecutors raided the offices and key branches of the four banks, as well as the homes of senior executives. Earlier this month, Mirae Savings Bank chairman Kim Chan-Kyong was arrested while he attempted to reach China by boat. He is reportedly alleged to have withdrawn about 20 billion won ($17.7 million) from his bank before trying to leave the country.

Since last year, the South Korean government has suspended 20 of the nation's 105 savings banks.

Savings banks in Korea are secondary financial institutions that typically lend to those unable to obtain loans from major lenders, such as Hana Bank or Shinhan Bank. In 2005, low interest rates triggered a property boom and savings banks greatly increased their lending to construction projects. Following the 2008 financial crash, the state-owned Korean Asset Management Corp (KAMCO) stepped in to provide a bailout of 1.7 trillion won ($US1.48 billion), buying up bad loans from these projects.

According to *Korea Herald*, in the decade after the 1997-1998 Asian financial crisis, a total of 8.5 trillion won of public funds were used to bail out troubled banks. Since the 2008 crash, savings banks have also benefited from the Deposit Insurance Fund established in 2003 to protect customers' savings in case of bank failures. Then in 2010, the KAMCO stepped in to provide additional public money, 2.8 trillion won, to cover construction related loans.

Despite the bailouts, many savings banks remain in deep crisis. South Korean officials have tried to downplay the risks of wider economic damage by stressing that savings institutions only account for about 3-5 percent of the banking sector. Risky lending, however, has not been limited to savings banks. Last year it was revealed that five major commercial banks were holding bad loans related to construction and real estate projects worth 3.3 trillion won.

The property market in South Korea has slumped amid the continuing global economic turmoil. Housing prices in Seoul have been falling for 10 consecutive months, with another 0.3 percent month-on-month decline in April. Only 15,181 apartments throughout the country were traded in January—a 76 percent drop from December and just one third of the volume for January 2011.

As well as being exposed to a domestic real estate bubble, South Korea's banking system is heavily dependent on international credit markets. Fitch Ratings and Moody's have both warned that South Korean and Australian banks are the most exposed in Asia to the European debt crisis.

As in the US and other countries, the South Korean bailouts only encouraged the banks to continue to engage in risky lending and speculative activities. At the end of March 2010, loans extended by banks to construction projects had increased to 11.9 trillion won, compared to 6 trillion won at the end of 2005. Loans considered to be risky increased from 45 percent in 2010 to 60 percent last year, while loans considered substandard rose from 10 percent to 20 percent in the same period.

Recent regulations imposed on construction project loans have seen savings banks turn to household loans, as workers have been forced to borrow to supplement declining wages. At the end of 2011, household loans had surpassed a record 10 trillion won, according to the *Maeil Economy* newspaper. Household debt in South Korea has reached record levels, climbing to 912 trillion won in 2011.

The economy's current dependence on debt-driven household expenditure is inherently unsustainable, and threatens to trigger further turmoil in the country's banking system.