

Another legacy of project financing loans – “Bank run” to Korean savings banks

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“Bank run” to savings banks

Since the beginning of 2011, 8 savings banks have been ordered by the Financial Supervisory Service (FSS) to halt their business for 6 months due to poor asset quality. Poor asset quality resulting from poor risk management on the lending side – heavy exposure to project financing (PF) loans – much of which have been negatively affected by the meltdown in the real estate market and the global financial crisis. The suspended savings banks' BIS ratios (bank for international settlements) are reported to be less than 5% or negative.

Several tens of thousands of people have flooded into savings banks to get their money back over the last couple of weeks. The biggest bank run amount so far was W495bn (\$442m) on Feb 21. In order to better understand the impact on the banking sector and possible effects on the construction sector, this article will summarize the state of play in the world of savings banks.



Source: Chosun Ilbo, February 22, 2011



Source: Source: Yonhap News, February 18, 2011

Savings banks in the Korean financial industry

Savings banks are second-tier (non-bank) lenders. Their client base is mostly small and medium sized enterprises (SMEs) as well as households. They have higher deposit rates and higher lending rates than banks. The total number of savings banks at the end of 2010 was 105, scattered around the country with aggregate assets of W86tn (\$76bn). There has been a restructuring process after the Asian financial crisis (from 231 at 1997 end), but it has proved to be insufficient.

Savings banks started their business in 1972 under the name of “mutual credit unions” as niche players targeting the sub-prime sector and changed their name to savings banks in 2002.

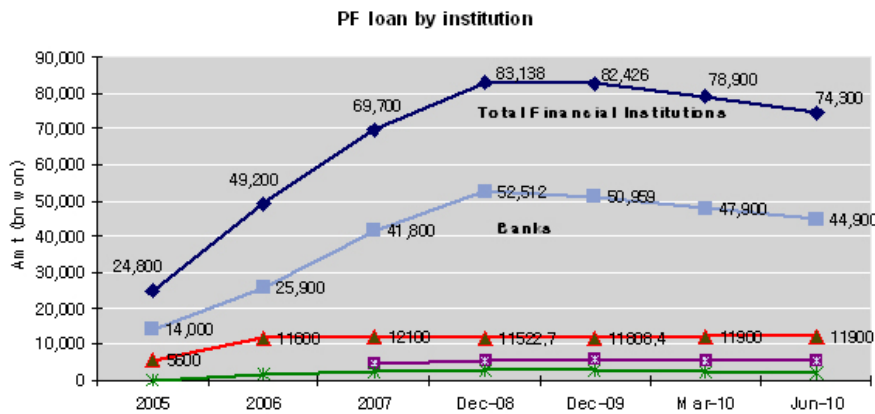
Savings banks with W1tn+ assets

(Unit: Wbn)	Total asset	Total equity	NPL ratio	NPL cov. ratio	Tier 1 ratio
Solomon	5,719	171	7.9%	59.2%	5.4%
Tomato	4,114	173	6.9%	42.6%	5.5%
Busan	4,080	238	14.2%	67.3%	5.7%
Cheil	3,654	233	6.3%	57.0%	4.7%
Busan 2	3,345	106	7.2%	98.3%	6.1%
Kyungki	3,170	202	5.8%	64.2%	8.1%
Hyundai Swiss	2,978	179	7.9%	66.3%	4.1%
Korea	2,679	218	6.8%	53.1%	5.3%
Jinhung	2,560	317	6.2%	68.9%	7.2%
HK	2,387	141	15.1%	44.1%	6.6%
Mirae	2,044	93	7.7%	44.9%	5.4%
Hyundai Swiss 2	1,824	116	6.5%	56.7%	7.6%
Daejun	1,766	(40)	16.4%	59.1%	-3.1%
Moa	1,694	70	5.2%	60.6%	6.3%
Dongbu	1,659	129	2.0%	79.7%	6.4%
Prime	1,578	57	5.4%	71.2%	4.8%
Purun	1,547	150	6.8%	48.5%	8.2%
Tomato 2	1,482	46	10.5%	53.5%	4.8%
Samwha	1,408	(14)	23.9%	43.0%	-1.4%
Shilla	1,384	47	13.8%	44.7%	3.5%
Busan Solomon	1,375	58	12.4%	48.4%	4.2%
Korea investment	1,160	151	2.5%	118.8%	16.2%
Cheil 2	1,090	56	7.8%	42.1%	6.4%
Seoul	1,068	(42)	38.7%	36.4%	-7.3%
Sub-total (A)	55,766	2,857	10.1%	59.5%	5.0%
Other 81s (B)	30,767	2,256	9.6%	56.6%	6.7%
Total (A+B)	86,534	5,114	9.7%	57.3%	6.3%

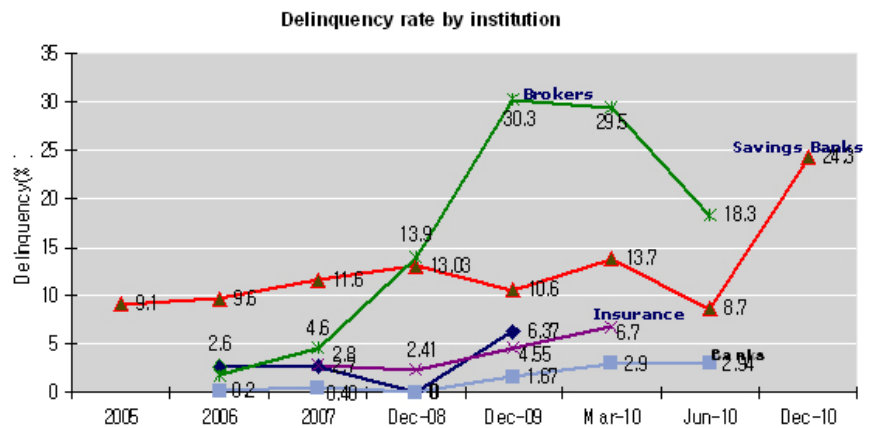
Source: The savings banks' financials based on June-2010: FISIS; BofA Merrill Lynch, Exchange rate of W1,120/\$1

At the end of 2010, the aggregate deposit was W76.8tn (\$68.6bn) and lending was W64.6tn (\$57.7bn) with 4.3m depositors and 1m lenders as clients. Total staff working for savings banks was 8.5k people in 376 different branches nationwide. To compare, at the end of 3Q10, a staff of 101.7 k were employed by banks working in 7,559 domestic and overseas branches. Banks total deposit/debentures was W1,421tn (\$1.27tn) and lending W1,197tn (\$1.07tn). Given the relatively smaller size of funding (c. 5.4% of banks') and loans (c. 5.4%), the impact of the bank run to savings banks will not be very serious on a fundamental basis. However, it does have some implications to banks earnings/assets going forward as more people are concerned about asset quality (flight to safety), and it also requires the banking sector to engage in a bail out mission. Heavy exposure to PF loans has changed the business structure of construction companies as well.

All deposits (principal and interest amounts) per individual in a single savings bank are guaranteed by the Korea Deposit Insurance Corporation (KDIC) up to W50m (\$44.6k). Savings banks usually provide higher deposit rates (c. 100 bps+) than banks, and their lending side is restricted up to W8bn (\$7.1m) per SME or PF. However, the loan restriction was eased in August 2006 for savings banks with relatively sounder asset quality. The criteria back then was a BIS ratio of 8%+ and a precautionary and below ratio of 8% - the so called "88 club". Savings banks satisfying the criteria were free from lending restrictions. They could lend more than W8bn to a single borrower, and project financing loans were widely spread out at that time backed by a strong real estate market. Furthermore, many PF loans to real estate developers were in the form of bridge loans with short maturities/roll-overs, and construction companies had to guarantee payback of principal and interest (off-balance sheet element). Of total assets of W87tn (\$77.7bn, 1H10), the PF lending balance was W11.9tn (\$10.6bn) – c. 14% of total assets – 70% (W8.6tn, \$7.7bn) of which are based on bridge loans, according to the FSC (Financial Supervisory Commission).



Source: Financial Supervisor Service(FSS), News Search



Source: Financial Supervisor Service(FSS), News Search

During the global financial crisis the bubble in the real estate market burst (like sub-prime mortgage in the US). Real estate developers (borrowers) had to roll over bridge loans on a quarterly/semi-annual basis, but unsold housing units hindered progress of the projects. Lenders had to set aside a provisioning amount and constructors also had to recognize payment guarantee risks on their book. Big banks and constructors have already recognized potential provisioning amounts during the last two years. However, savings banks were quite behind in setting up proper provisioning amounts due to inferior management quality, and they are now forced to do so by the regulators. Obviously, the results are not good: low BIS ratio, high precautionary and below ratio, high non-performing loan ratio, high credit cost... down to negative shareholders funds... to bank runs!

Ailing 11 savings banks vs. the industry

(Wbn, %)	Asset	Liabilities	Equity	BIS (%)	NPL (%)	Total loans	NPL
Ailing 11 Savings Banks	14,118	14,202	(84)	5.49	14	10,200	1,427
Average of Ailing Savings Banks	1,283	1,291	(8)		14	927	130
Weight	16.30%	17.40%	-1.60%			16.10%	23.10%
Total savings bank industry (Wbn, %)	86,534	81,420	5,114	9.25	9.7	63,402	6,166

Source: FSS and News search, Exchange rate of W1,120/\$1

Total assets of 11 ailing savings banks are W14tn (\$12.5bn) – 16.3% of total industry assets, only 1.3% of four major financial holding companies – Shinhan, KB, Woori and Hana – and 0.8% of total assets of the banking sector. Negative shareholders' funds by 11 savings banks is c. W84bn (\$75m), and it can be covered by KDIC guarantee – less impact to any purchasers.

The government stance

As many clients of saving banks are people in the low income bracket, the government must consider the political implications as well. Plus, the geographic scattering throughout the nation seemed to have been a factor for no active clean up of ailing savings banks for the last 2-3 years.

Recognizing the seriousness of the problem and with no major elections this year, the government stance has changed to disclose all/possible bad savings banks to the public and separate those from “fine” savings banks – this will allow the public to identify which ones are ‘relatively’ safer. The openness has been working effectively so far, and bank runs have come down. Out of 105 savings banks, 8 are suspended, 3 are under severe restructuring by the FSS, and 94 are operating normally.

Concerned about shaky PF loan exposure, the government was trying to normalize ailing savings banks via forming MOU (memorandum of understanding) contracts with 61 savings banks in July 2010. KAMCO (Korea Asset Management Corporation) has spent W2.5tn (\$2.2bn) in 2010 purchasing distressed PF loans from savings banks. Since the Asian financial crisis, Korean financial regulators have poured W17.3tn (\$15.4bn) into ailing savings banks up until Nov 2010. Also, the government prepared W3.5tn (\$3.1bn) for restructuring funds and pursued consolidation amongst savings banks, which seems to have failed for now. One of the reasons was “good + bad = bad”, because the acquirers' financial conditions were not far better than the acquirees'. There seems to be a bi-polarization in selling ailing savings banks. Savings banks with better geographical positions - Seoul metropolitan areas - are more attractive to many bidders than the ones in inferior rural areas.

Regulation change going forward

Poor management on the lending side has not been detected by depositors and investors due to less sophisticated regulations: unlisted savings banks are required to only disclose bi-annual financial statements. Stricter disclosure rules are required; mandatory quarterly disclosure has been introduced for more transparency.

The government funding plan looks to be up to c.W20-22tn (\$17.8-19.6bn) in total, supported by the National Assembly to use KDIC's bank's deposit for savings banks (currently, the amount is only for the bail out of banks, not for other financial institutions). 4 major commercial banks are also providing W1.6tn (\$1.4bn) bail out money, 50% of which will be guaranteed by KDIC. Thus, the actual burden for them won't be big.

Consolidation is another step to follow, including M&A (mergers and acquisitions) and P&A (purchase of assets & assumption of liabilities) methods for the remaining 94 as well as for those 11 ailing companies. Risk management skills remain challenging, and standalone businesses with thin balance sheets would not be sustainable on a long term basis.

Major shareholders of savings banks will be strictly audited in the future. Other measures to be implemented are the abolition of the “88 club” and restrictions on retired former employees of regulatory bodies joining savings banks.

The first bail out by bank – implications to banking sector

The first suspended victim in mid Jan this year – Samhwa Savings Bank – is to be sold to Woori Financial Holdings (WFH), through a bidding process, for a fresh cash injection of c. W100bn (\$893m) and the shortfall will be supported by KDIC. Apart from WFH, KB Financial Holdings and Shinhan Financial Holdings also submitted proposals to purchase Samwha. This is the first execution of a bail out by the banking sector. According to Bank of America Merrill Lynch, a single acquisition would cost a commercial bank W100-300bn (\$89-268m).

The financial condition of Samhwa at June end 2010 was negative shareholders’ funds of W50.4bn (\$45m) with BIS ratio of -1.4% (however, 8.73% a year ago). Total asset were W1.4tn (\$1.2bn), comprising 1.5% of aggregate industry assets, and net loss in FY 2009 was W91.4bn (\$81.6m) due to large provisioning (W115.7bn, \$103.3m) caused by PF loans.

The restructuring process that WFH will implement includes setting up a new paper savings bank that will purchase assets and liabilities from the ailing savings bank – P&A – with put option clauses due to the uncertain future value of the PF loan balance. Any deposits that are beyond the legal hurdle of W50m (\$44.6K) won’t be included in the deal, and those depositors may be faced with a loss. The purchase amount equates to only 0.6% of shareholders’ funds (W17tn, \$15.2bn) of WFH at 2010-end, thus a very minimal financial impact, but perhaps by having a savings bank business under financial holdings they may increase their niche market business.

Comparison between savings banks and the banking sector

(W tn)	Savings banks	Percentage of banks	Total commercial banks
Total asset	86.5	5.00%	1,720.90
Total liabilities	81.4	5.10%	1,607.10
Total equity	5.1	4.50%	113.8
System leverage (x)	16.9		15.1
Gross loans	59.8	5.00%	1,199.40
Total deposits	76.4	7.80%	974.3
Total number of deposit (mil)	4.3		

Source: FSS and News search, Exchange rate of W1,120/\$1

We have 7 more to go, and more active involvement by various banks is naturally expected. As shown in WFH’s case, a bail out for distressed savings banks will not cost much from a banks’ perspective, but may provide the opportunity to expand to other business areas. Purchasing more savings banks at reasonable prices and combining them under a bank’s brand should pay off some day. It could be a positive investment on a bank’s earnings, in theory. It doesn’t look an entirely bad strategy. Normalized contribution from savings banks can be c. 5% of financial holdings earnings power. The key is how fast normalization is achieved.

One of the key concerns in the stock market is that banks may be faced with involuntary bail out pressure by the government. This could cause an increase in the discount factor for valuing Korean banks, unfortunately.

Implication to construction companies

As shown above, total PF loans outstanding as of 1H10 were W74.3tn (\$66.3bn), falling (-10.5%) from the peak of W83.1tn (\$74.2bn) at the end of 2008. However, PF loans by savings banks haven't reduced yet, staying at W11.9tn (\$10.6bn) – meaning “not enough provisions have been made”. In contrast, most of banks have recognized large provisioning amounts in 2010, especially in 2H10. Many big construction companies have been active in provisioning since 4Q08 as well.

The figures include PF loans for land where digging has not yet begun. Construction works not yet started will have a milder impact on lenders as well as construction companies, because simple cancellation of works would be a solution to minimize the financial burden. In this situation, developers would have to bear most of the negatives, which in turn causes trouble with construction companies who provided guarantees, as developers don't have much money without commencing projects. This is, however, better than the worst situation - significant unsold units.



Source: Korea Economy Magazine_January 2009



Source: Maeil Business Newspaper on July 8, 2008

PF guarantee balances by the 6 biggest constructors at 3Q10 end (shown below) were still at high levels (W13.2tn, \$11.8bn, reduction of -7% for 7 quarters), compared with the peak of W14.2tn (\$12.7bn) at 4Q08. These figures are for pure development projects and did not include relatively safer guarantees for re-construction and re-development works. Many of them may be cancelled or unrealized, in theory, unless we see steady pick up of the real estate market. Less supply of housing from the private sector can be a problem in the future, but not in the immediate future. No active housing supply has resulted in big construction companies heading for overseas countries, especially to the Middle Eastern region.

(unit: W tn)	4Q 08	1Q 09	2Q 09	3Q 09	4Q 09	1Q 10	2Q 10	3Q 10
Samsung C&T	0.5	1	1	1.1	1.4	1.4	1.2	1.2
Hyundai E&C	1.5	1.5	1.8	1.9	1.9	1.9	1.9	1.8
Daewoo E&C	3.9	3.8	4.4	4.5	4.4	4.2	4	4
Daelim Ind.	3.1	2.8	2.7	2.6	2.4	2.6	2.5	2.5
GS E&C	4.2	4.2	4	3.7	3.1	3.2	3.2	3.1
Hyundai Dev.	1	0.9	0.8	0.8	0.8	0.8	0.6	0.6
Total	14.2	14.2	14.6	14.7	14	14	13.4	13.2

Source: BofA Merrill Lynch, Exchange rate of W1,120/\$1



Now, MENA (Middle East and North Africa) markets!

The situation is getting worse for the businesses of Korean constructors, at least for now. No or less spill over of “unrest” into their main client countries (UAE, Saudi Arabia, Kuwait etc.) would bring a decent recovery of the business expectations of engineering and construction companies. For now, the influence of Mr. Mad Dog in Libya is negatively impacting Korean constructors that are also facing limited growth in their domestic market.

However, once all the dust is settled – hopefully starting from MENA markets – we would expect to see a strong recovery of stock prices.