October 14, 2008

Text of Governor Kim Jong Chang's Conference Call with Institutional Investors

The following is the text of the opening remarks FSS Governor Kim Jong Chang made at a conference call with institutional investors and market analysts at 6:00 p.m. (KST), Monday, October 13, 2008. The text has been edited for clarification.

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Good evening, ladies and gentlemen.

I am Kim Jong Chang, Governor of the Financial Supervisory Service of Korea. I would first like to thank Goldman Sachs for arranging today's conference call and giving me an opportunity to discuss recent market developments and the situation in Korea.

Markets worldwide are experiencing a severe distress. The impact is being felt in Korea as elsewhere, and some questions have been raised about the liquidity conditions and the soundness of Korean banks. So I very much appreciate the opportunity to share with you our assessment of Korean banks' financial soundness as well steps the market can expect from the regulators going forward.

<u>Overall bank soundness</u>

Let me start with financial soundness of Korean banks. The soundness of Korean bank has been steady and robust in terms of earnings, asset quality, capital strength, and other soundness measures.

The ROA of Korean banks stood at 0.88% at the end of the first half this year, which compares favorably with those of banks in the developed countries. The ratio of nonperforming loans is at a historic low of 0.6%. With respect to capital strength, the coverage ratio stands at 197% and the BIS capital ratio at 11.4%, which suggests that Korean banks are more than adequately capitalized to absorb any likely future loan losses.

Korean banks' exposure to troubled assets abroad is insignificant. The size of investment of local banks in mortgage-related securities—i.e., mortgage-backed securities and collateralized debt obligations—is estimated at about US$70 million. Exposure to Fannie Mae and Freddie Mac is estimated at about at US$120 million.

Bank liquidity

With respect to liquidity, an issue under the spotlight right now both at home and abroad, Korea has instituted one of the toughest prudential regulations on three-month liquidity ratio for banks since the 1997 financial crisis. As a result, the three-month won and foreign currency liquidity ratios of domestic banks exceeded the 100% mark at end-September. The seven-day gap ratio stood at 2.8%.

I am well aware of concerns expressed by some observers here and elsewhere about this issue. The concern is that the higher-than-usual loan/deposit ratio of Korean banks suggests they are funding domestic lending with foreign borrowing.

I wish to state as clearly as I can that this is simply not the case at all. Korean banks' loan/deposit ratio—including CDs—was 103.2% at the end of September. Because of their deposit-like characteristics, CDs are included in determining the loan/deposit ratio, as is the convention in many countries. I would also note that CDs are treated as deposit liabilities under the Bank of Korea Act and thus subject to strict reserve requirements. I would further note that over-the-counter bank teller sale of CDs accounted for about 80% of the total bank CD issues. It should also be pointed out that the loan/deposit ratio drops to about 85% if bank-issued bonds are included in the ratio computation, meaning funding from local sources easily covers local lending.

As for domestic banks' foreign currency liabilities, the total came to US$235.3 billion at the end of August. Foreign currency assets, on the other hand, totaled US$229.4 billion. What these figures tell you is that close to 98% of foreign currency borrowings are held and managed in foreign currency. So, again, I emphasize that it is simply not the case that Korean banks are funding local lending with foreign borrowing.

Bank loan growth and asset soundness

Let me say a few words about loan growth and asset soundness of the banking sector.

Since 2005, banking lending has grown at about 10% a year on the back of abundant market liquidity and rising credit demands in the real sector. I think it's important to note that the loan growth during this period was driven to some extent by credit demands from the export sector that had been growing at a robust pace of around 15% a year.

It is also likely that the loan growth at least partially reflects the normal rebound in business lending, which contracted sharply following the 1997 financial crisis and remained sluggish for some time.

Given the overall strength of Korean banks and the low corporate debt ratio, our broad assessment is that local banks' loan growth has not outpaced their ability to easily absorb potential losses ahead.

Household debt

The ratio of household financial debt to disposable income stood at 148% at the end of 2007, a level in line with what is observed in the U.S. and in the U.K.[1] It is important to point out that a large portion of domestic household financial assets is held in liquid assets, such as deposits and cash (42.9% versus 13% in the U.S. and 26% in the U.K.). As such, the expectation is that household liabilities can be offset with assets with relative ease.

Mortgage loans

Let me also address a few issues connected with the soundness of mortgage loans.

Korean regulators have imposed several tough prudential measures on mortgage lending well before the breakout of the subprime crisis in order to ensure soundness of mortgage loans. The key measure is a conservative loan-to-value ratio between 40 and 60% (in effect since 2002) and an equally conservative debt-to-income ratio only up to about 40%.

As a result, the overall LTV ratio came to about 47% at the end of June this year. With loan default at 0.4% and loan loss provisioning at 312%, domestic banks continue to show sound and safe mortgage asset management.

It has been observed that countries now suffering from distressed mortgage loans saw their housing prices jump two to three times during the last decade or so. During the same period, housing prices rose about 65% in Korea. So, I think the likelihood of a sharp drop in housing prices is quite low.

I must also stress that, unlike in some developed countries, securitization of mortgage assets has been negligible in Korea, there are no mortgage-backed derivatives, and we have a firm grip on mortgage loan exposure of domestic banks.

Again, given the low LTV ratio and modest housing price increases, I think we can safely dismiss the likelihood of a collapse in housing sector triggering a banking crisis.

[1] The term "financial debt" is used to denote household borrowings from financial institutions. Likewise, the term "financial assets" refers to financial assets of households.

SME loans

Let me quickly turn to corporate lending.

In terms of structural soundness, Korean companies' debt ratio averaged 107% at the end of 2007, about a quarter of what it was a decade earlier. Interest coverage ratio, which measures the debt-servicing ability of companies, improved substantially from a factor of 1.2 to 4.1 during the same period.

As for SME loans, bank lending to SMEs has been growing at a good pace since 2006 with the improving economy. But the overall default rate for SME loans stands at 1.5%, and all the lenders have set aside ample provisions against potential losses.

I would add that the government plans to come up with credit support measures totaling about KRW8.3 trillion through several state-run institutions in order to alleviate SMEs from temporary credit difficulties.

Foreign currency liquidity

Let me now make a few observations about foreign currency liquidity.

You should not be surprised that Korean banks have recently encountered some difficulty securing funds from foreign lending institutions because of the ongoing global credit crunch.

Let me again stress that, as I noted earlier, we have maintained tough prudential regulations on foreign currency liquidity ratios, and our assessment is that domestic banks have managed their foreign currency liquidity positions in a sound fashion.

The liquidity conditions for Korean banks have improved considerably as well after the government made available US$5 billion to the commercial banks through the Export-Import Bank of Korea.

As for maturing external debt, the total amount due (excluding the small regional banks) during the fourth quarter this year comes to about US$ 32.7 billion. While domestic banks are running to some difficulty raising longer-term funds, they have no difficult with overnight funding.

The government has also made it clear that Korea's usable foreign currency reserves are close to US$240 billion and that it would take the steps necessary to make sure domestic banks do not run into any difficulty servicing their overseas debt obligations.

Summary

I would like to conclude my remark by reiterating several points I made earlier.

First, domestic banks remain sound and healthy. Second, with tough prudential standards on mortgage lending, the LTV ratio, currently at 47%, is well managed, and the overall mortgage default rate stands at about 0.4%.

The default rate for SME loans is at a low 1.5%. The government has also pledged appropriate liquidity support to SMEs facing temporary credit problems.

Domestic banks' loan/deposit ratio stands at 103.2%, or 85% when bank-issued bonds are included in the ratio computation. And it is simply not the case that Korean banks are funding their local lending with foreign borrowing. It is funding from local sources that Korean banks are primarily using for local lending.

The foreign currency liquidity positions of domestic banks are well regulated and soundly managed.

And the government stands ready to take steps necessary to ensure a steady flow of credit in the market.

Thank you.