

## Korea Banks

### The new household debt management plan: even higher DSR if without income growth

#### Equities

Korea  
Financial

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#### Government released a comprehensive household debt management plan

Today, the government including Financial Services Commission (FSC) collectively released measures to manage the rising household debt burden in Korea. The key initiatives included 1) Further restructuring of household debt to amortized / fixed-rate structures; 2) Emphasis on repayment ability during the loan underwriting process; 3) Curbs on non-bank credit growth; and 4) Overall enhancement of household debt risk management through capital buffers and household debt monitoring, among others.

#### In line with regulatory target of reducing household debt /disposable income

We view the plan as a strengthened extension of FSC's target announced last year, to lower household debt/disposable income from 160% in 2013 to 155% in 2017. We believe the measures encourage financial institutions to slow down household loan growth; in particular, we focus on the raised target of amortized (i.e., principal repayments begin with no/less than 1 year interest-only periods) mortgages within total mortgage book to 35%/40%/45% in 2015E-2017E from 25%/30%/40% previously.

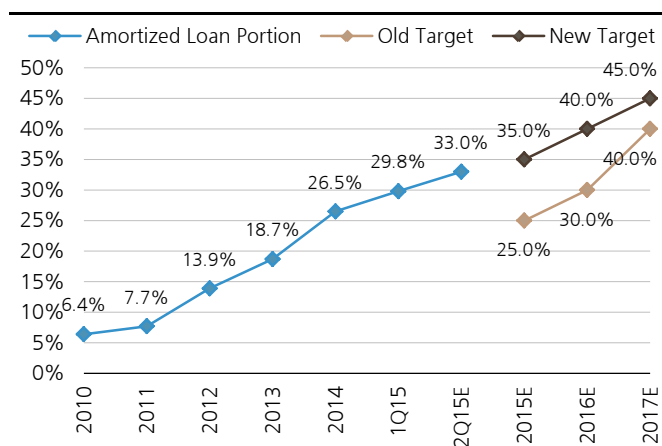
#### Necessary measures but distressing for banks' loan growth and asset quality

Given that Korea's ever-rising household leverage was heavily attributable to a lack of principal repayments, encouraging principal repayments via regulatory targets could be effective in reducing household debt/disposable income. However, unless factoring in a strong income growth the increased principal repayments should further raise Korea's already high debt service ratio (DSR) despite low interest rates; which in turn puts negative pressure on asset quality, property markets, and consumption. For banks that means negative pressure on both growth and asset quality: On our calculation a 45% amortized loan portion equals a c2.25%pt downside pressure on mortgage growth per year (i.e., c0.6%pt/year extra downside from 33% amortized loan portion currently). Sharing the same concern, government aims to enhance income through expansionary fiscal policy, employment, higher minimum wage, and tax measures promoting dividends, wage increase, and investments – which remains to be seen for now.

#### Limited downside after -32% since Sep 2014; remain cautious fundamentally

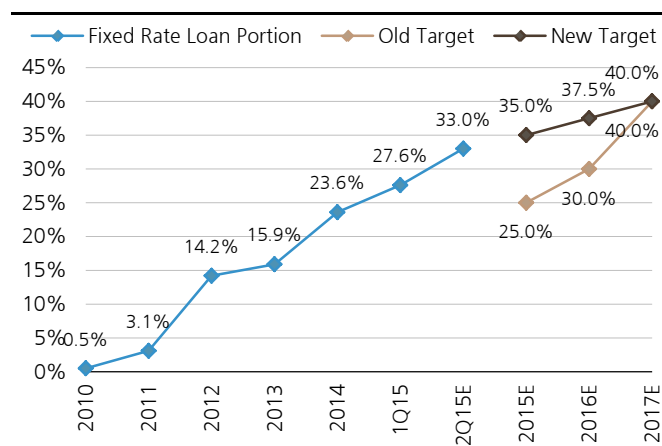
Sector trades at 7.5x 2015E P/E and 0.5x P/BV: a level supporting a near-term upside. However given the fundamental concerns on the sector we remain cautious.

**Figure 1: FSC's amortized mortgage loan portion target**



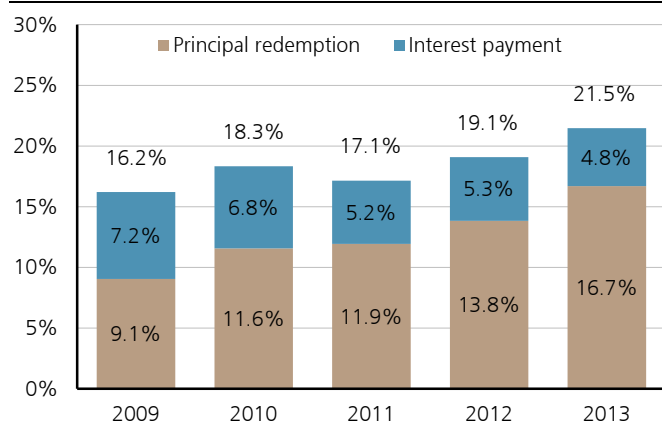
Source: Financial Services Commission

**Figure 2: FSC's fixed rate mortgage loan portion target**



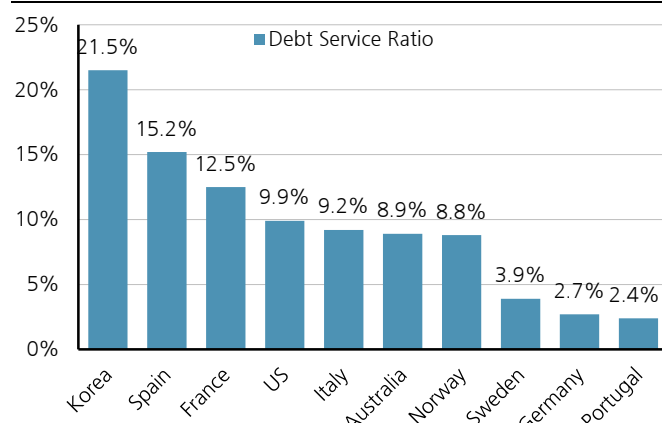
Source: Financial Services Commission

**Figure 3: Household debt service ratio continued to rise despite low rates, due to increased principal redemptions**



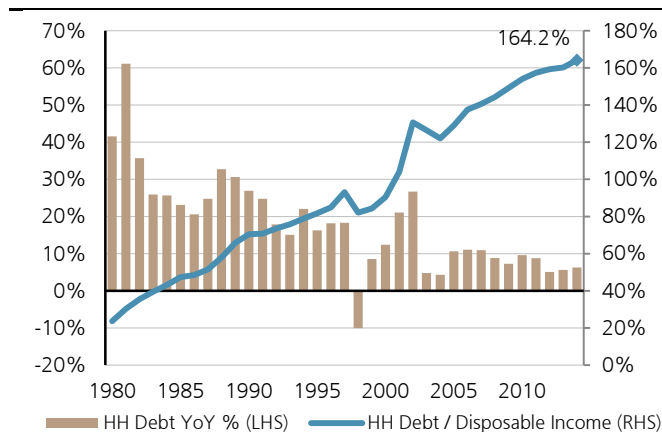
Source: KOSTAT, Bank of Korea, UBS estimates for 2009-10

**Figure 4: Korea's household debt service ratio is among the highest in the world**



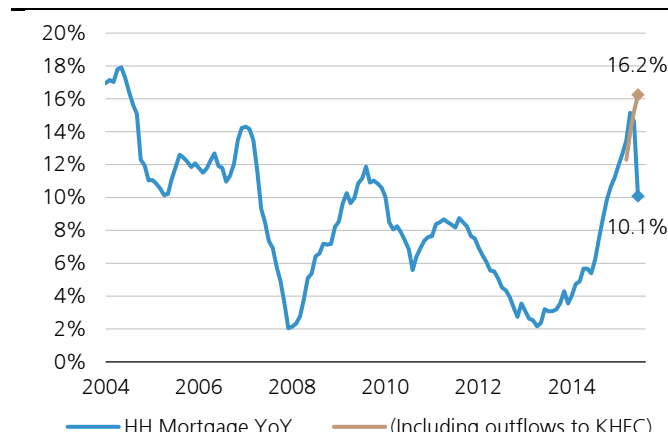
Source: KOSTAT, IMF Financial Soundness Indicators (2014), Maekyung

**Figure 5: Household debt / disposable income**



Source: Bank of Korea, Quantiwise

**Figure 6: Bank household mortgage loan growth YoY**



Source: Bank of Korea

**Figure 7: Details of the household debt management plan**

	Before	After
<b>1. Restructuring of debt to "amortized" structure</b>	Majority of mortgage loans were bullet loans / or with interest-only periods Average 3-5 years of interest-only period Target amortized loan portion 40% by 2017E	Majority of new mortgage loans encouraged to be amortized in principle Encourage to reduce interest-only period <1 year Target amortized loan portion 45% by 2017E
<b>2. Enhanced assessment of borrowers' ability to repay</b>	Focus on collaterals	Focus on borrowers' ability to repay
* Strengthened income identification	Determination of borrowers' income level based on a generous estimation (and potentially overestimation) using credit card usage etc. Minimum cost of living included in income	Stricter measurement of borrowers' income, based on official data only. Cautious underwriting on borrowers lacking official income data Minimum cost of living excluded from income
* Limit on leverage	Credit limit set based on LTV/DTI - no restriction on the structure (amortized - bullet)	High leveraged borrowers encouraged to switch to amortized loans
* Risk of potential interest rates (floating rate loans)	Not considered	Reflected as a factor lowering credit limits
* Assessment of repayment burden for other (non-mortgage) loans	Consider interest payments only	Consider principal repayment burden as well as interest payments
<b>3. Curb on non-bank financial institution loan growth</b>	Flexible upward adjustment of credit limit Collateral value allowance of >60% Interest income on mutual credit deposit were tax-exempt	Upward adjustment only allowed when risk factors decrease Collateral value allowance of >50%; to be further reduced gradually Gradual reduction of tax-exemption (100% exempt in 2015; 5% in 2016; 9% from 2017)
<b>Conclusion</b>	Structurally rising household debt Easy to receive loans exceeding the ability to repay Fast growth of non-bank financial institution credit	Structural repayment of debt Loans extended in consideration of the ability to repay Tightened growth of non-bank financial institution credit

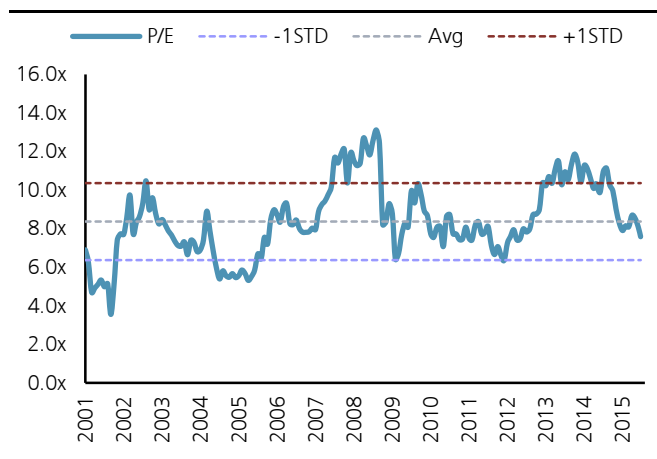
Source: FSC

**Figure 8: Calculation of impact on loan growth from higher amortized mortgage portion**

	Calculation	
Ongoing impact on loan growth		
Amortized mortgage / total mortgage (current)	<i>a</i>	0%
Amortized mortgage / total mortgage (2017E target)	<i>b</i>	45%
Increase in the portion of amortized mortgage	<i>c=b-a</i>	45.0%
Average mortgage maturity	<i>d</i>	20
% of mortgages that should be repaid annually = annual impact on mortgage growth	<i>e=c/d</i>	-2.25%
Mortgage / total loans for banks (excl. specialized banks)	<i>f</i>	36%
Annual impact on total loan growth	<i>g=exf</i>	-0.81%
Ongoing incremental impact on loan growth vs. 33% in 2Q15E		
Amortized mortgage / total mortgage (current)	<i>a</i>	33%
Amortized mortgage / total mortgage (2017E target)	<i>b</i>	45%
Increase in the portion of amortized mortgage	<i>c=b-a</i>	12%
Average mortgage maturity	<i>d</i>	20
% of mortgages that should be repaid annually = annual impact on mortgage growth	<i>e=c/d</i>	-0.60%
Mortgage / total loans for banks (excl. specialized banks)	<i>f</i>	36%
Annual impact on total loan growth	<i>g=exf</i>	-0.21%

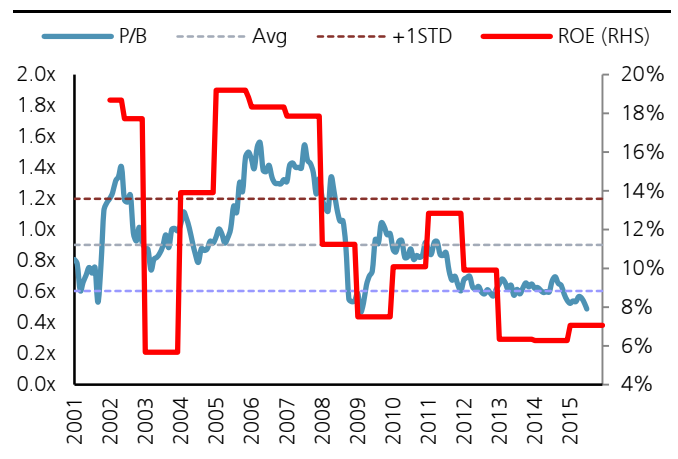
Source: UBS estimates

**Figure 9: 12M roll forward sector P/E**



Source: UBS estimates

**Figure 10: 12M roll forward sector P/BV**



Source: UBS estimates

UBS reports for reference:

**Korea: Lower Rates With Higher Debt Service (Mar 2015)**

<https://neo.ubs.com/shared/d1Hdi4oaFXISC>

**Korea Banks: Will Korea Banks Enter a 'Lost Decade'? (Mar 2015)**

<https://neo.ubs.com/shared/d1VNAQT2BRMN>

**Statement of Risk**

We believe the key risks for the Korean banking sector include yields, property prices, and currency. 1) Further declining yields are negative for banks' interest margins. 2) Due to Korean households' high leverage to property, property price movements can significantly affect consumption and household loan asset quality. 3) Significant Won appreciation from current levels could negatively impact corporate asset quality and consumption.

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<b>Neutral</b>	FSR is between -6% and 6% of the MRA.	42%	32%
<b>Sell</b>	FSR is > 6% below the MRA.	13%	20%
Short-Term Rating	Definition	Coverage <sup>3</sup>	IB Services <sup>4</sup>
<b>Buy</b>	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
<b>Sell</b>	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 30 June 2015.

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<b>BNK Financial Group</b>	138930.KS	Neutral	N/A	Won13,750	21 Jul 2015
<b>DGB Financial Group</b>	139130.KS	Buy	N/A	Won11,200	21 Jul 2015
<b>Hana Financial Group</b>	086790.KS	Neutral	N/A	Won28,300	21 Jul 2015
<b>Industrial Bank of Korea<sup>2, 4</sup></b>	024110.KS	Neutral	N/A	Won13,350	21 Jul 2015
<b>KB Financial Group<sup>16</sup></b>	105560.KS	Neutral	N/A	Won34,950	21 Jul 2015
<b>Samsung Card</b>	029780.KS	Neutral	N/A	Won37,550	21 Jul 2015
<b>Samsung Fire &amp; Marine Insurance</b>	000810.KS	Buy	N/A	Won281,000	21 Jul 2015
<b>Samsung Life Insurance</b>	032830.KS	Buy	N/A	Won102,000	21 Jul 2015
<b>Shinhan Financial Group<sup>16</sup></b>	055550.KS	Buy	N/A	Won39,850	21 Jul 2015
<b>Woori Bank<sup>16</sup></b>	000030.KS	Neutral	N/A	Won9,040	21 Jul 2015

Source: UBS. All prices as of local market close.

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