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Policy Issue in Focus

Promoting REITs to Revitalize Domestic Property Market

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Promoting REITs to Revitalize Domestic Property Market

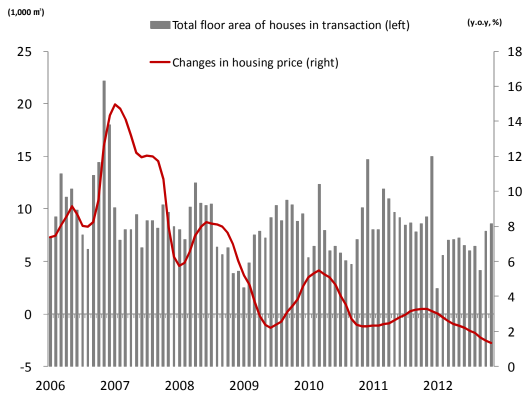
JiEun Lee

Summary: The lack of diversity in property market participants is one of the reasons for the prolonged slump in real estate market. To turn around the property market, it is important to foster the market for REITs and real estate funds, and broaden the scope of market participants. To this end, a niche market should be explored to accommodate a wider variety of smaller funds by easing requirements on IPO and allowing more discretion for dividend payment.

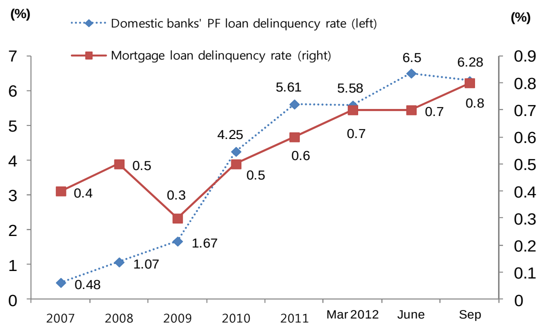
Currently, in Korea, the property market is severely slumped amid the eurozone debt woes and persistent aftermath of the 2008 global financial crisis. Housing price continues to fall, and the volume of transaction has fallen significantly although the condition varies by regions depending on their residential and educational environments. The market for commercial properties is also sluggish, and companies might soon begin to load them off as a part of restructuring efforts if the rent and occupancy rate continues to decline. These raise concerns for soundness of financial institutions, as well as for deterioration of construction industry (Note: Between end-2007 and September 2012, the mortgage delinquency rate rose from 0.4% to 0.8%, and the delinquency rate for banks' PF loans climbed from 0.48% to 6.28%).

One of the reasons behind the property market slump is a lack of variety in market participants. Market pricing is not working efficiently due to a significant bid-ask price gap as sellers ask for high price to avoid loss and the potential buyers bid for low price expecting a further price fall. Such discrepancy indicates a lack of market depth due to a small market size and the limited scope of participants. Many buyers are often reluctant to engage in real estate transactions as the related data (e.g. type, price, condition of properties) is not disclosed in a transparent manner, and thus, people rely heavily on agents.

<Graph 1> Property Market Trend



<Graph 2> Loan Delinquency Rate

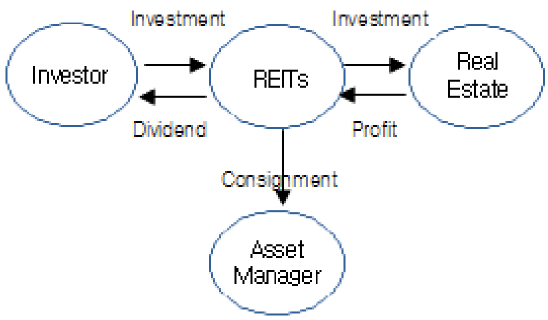


Under this circumstance, it will be essential to expand the scope of market participants and deepen the market. To do so, real estate transactions for rental and investment should also be promoted, with active use of REITs and real estate funds. Unlike project financing that relies on guarantee of construction companies, REITs draw funds from capital markets, and thus, it can contribute to revitalizing the chilled property market in a sound manner.

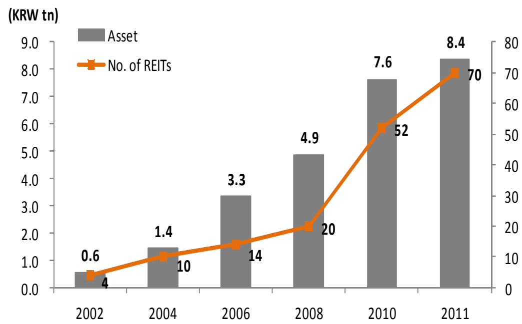
The market for REITs has not grown big enough to be a mainstay in the property market yet, and the government needs to redouble efforts by easing regulations and encouraging indirect investment in the market. The REITs Act was enacted in 2001 and as of the end of 2011, 70 investment trusts were being managed in the amount of KRW8.4 trillion. Meanwhile, the real estate funds were adopted in 2004, rising fast as a profitable investment instrument amid a low interest rate environment. By end-2012, the asset of the funds amounted to KRW20 trillion; however, 95% of them are private equity funds managed by large institutional investors, and the investment is concentrated in commercial properties of considerable scale. At a cabinet meeting held in June 2012, a proposal was passed to revise the REITs Act to enhance autonomy of its management and promote participation of institutional investors such as the National Pension Fund (Note: The revision includes raising the ceiling for equity ownership from 30% to 50%, eliminating the ceiling for the share of in-kind capital (currently at 50%), and extending the period of IPO after business permit (from six months to one and a half year)).

Additionally, it is necessary to enhance related policies to accommodate a wider variety of smaller funds in the market, thereby promoting indirect investment. Such measures could include easing regulations on IPO requirements, minimum capital and dividend schemes. Currently, a REIT needs minimum KRW500 million as initial capital, and it should go on a public offering within six months of acquiring business permit, and raise KRW7 billion as capital. As for the dividend, it should pay over 90% of profits as dividends since it is not allowed to re-invest profits. This increases a burden of loans to pay out dividends. Meanwhile, tax policies for real estate funds need to be revised to encourage participation of retail investors in smaller sums. These efforts would help create a niche in residential property market.

<Graph 3> REITs Structure



<Graph 4> Asset Volume of REITs



News Briefs

Domestic Banks' Loan Delinquency Rate Rises over 1%

The FSS said in a statement that the 18 domestic banks' delinquency rate of won-denominated loans recorded 1.0% as of end-December 2012, up 0.11%p from a year earlier (0.89%). It fell by 0.30%p from the previous month (1.30%) as banks wrote off a considerable amount of debts before the end of the year. As of the end of 2012, domestic banks' outstanding amount of won-denominated loans amounted to KRW1.106 trillion, an increase of KRW37.9 trillion from a year ago. The growth rate was 3.5%, much lower than a year before (7.8%). Among them, outstanding amount of household loans was KRW464.5 trillion, a slight increase of KRW12 trillion or 2.7%, from the previous year. Its growth rate was also lower than the previous year (5.8%). The FSS will guide banks to strengthen risk management, especially in vulnerable areas, and to enhance loss-absorbing capacity by writing off bad debts in the early stage to maintain financial soundness.

Significant Decrease in Fluctuation of USD/KRW Exchange Rate

According to the BOK, during 2012, the intra-day and two-day fluctuation of USD/KRW exchange rate was KRW4.2 and KRW3.3 respectively, much smaller than KRW7.2 and KRW5.6 in the previous year. This is mainly because market participants grew less sensitive to the eurozone crisis, and domestic FX policies were tightened including a lower cap ceiling on FX derivatives positions. As of end-2012, the USD/KRW exchange rate was 1,070.6, down KRW81.2 in a year (or a 7.6% appreciation), and the JPY/KRW exchange rate (for JPY100) was 1,238.3, down KRW243.1 (or a 19.6% appreciation) from the previous year. In 2012, the daily volume of inter-bank FX trading via FX brokerage services recorded USD21.59 billion, growing 1.4% in a year. Among them, FX swaps took the largest share (USD10.9 billion). Over the same period, non-residents net sold USD2.94 billion of NDF, after recording a net purchase of USD14.55 billion in 2011. Meanwhile, the average daily trading volume of NDF fell by 10.6% in a year to USD5.48 billion.

Issuance and Management of Sovereign Bonds in 2013

This year, the Korean government plans to issue sovereign bonds worth KRW79.7 trillion, and the Ministry of Strategy & Finance (MOSF) plans to revise regulations on issuance of sovereign bonds and operation of a primary dealer (PD) system. Accordingly, the sovereign bond system will be altered, and efforts will be made to keep a better balance between short-term and long-term markets, enable effective monitoring of the market in advance and timely response to the market conditions. Also, the benchmark bond will be changed from a 5-year to a 10-year bond, and the buyback option will be modified. The PD evaluation system will be revised as well to include records of bond exchange and EFT holding in assessment. Additionally, bidding time for 30-year and 3-year sovereign bonds will be adjusted, and the bid deposit for the KRX will be waived. These changes are due to be effective from February.

Market Indicators: Jan. 21-25, 2013

		2012 Avg	Dec Avg	Jan 21	Jan 22	Jan 23	Jan 24	Jan 25
Interest Rates (%)	Call Rate (1d)	3.09	2.75	2.76	2.75	2.75	2.75	-
	CD Rate (100 mil. Won)	3.32	2.88	2.85	2.85	2.85	2.84	2.84
	Industrial Finance Bond	3.26	2.89	2.76	2.76	2.76	2.76	2.76
	Corporate Bonds (3yrs Unsecured AA-)	3.80	3.31	3.19	3.17	3.15	3.13	3.12
	Korean Treasurys (3yrs)	3.15	2.85	2.74	2.73	2.72	2.71	2.71
	Nat'l Housing Bonds (5yrs)	3.46	3.09	2.97	2.96	2.95	2.94	2.94
KOSPI & Trade Value (KRW 100 mil.)	KOSPI (1 Jan 1980 =100)	1,930.79	1,973.84	1,986.86	1,996.52	1,980.41	1,964.48	1,946.69
	Trading Value	48,246	42,118	38,187	42,588	42,034	45,566	49,671
	Investment Balance	180,131	174,204	175,494	174,367	173,372	172,535	-
	Foreigner Net Purchases	711	1,989	-1,837	-2,032	163	-1,936	-1,936
FX Rates	Won/Dollar	1,126.43	1,076.15	1,062.90	1,062.30	1,066.20	1,068.70	1,074.50
	Won/Yen	1,411.99	1,283.31	1,186.27	1,204.42	1,204.75	1,181.93	1,188.34
	Won/Euro	1,448.20	1,412.69	1,414.08	1,413.18	1,418.15	1,428.85	1,436.61

Tasks of Korean Financial Industry in 2013

Sang-ho Sohn

Abstract: In the wake of the 2008 global financial crisis, the paradigm of the financial industry is shifting across the globe; and Korea is faced with tasks to resolve the current issues and establish a new framework. Customized policies should be devised so that large financial institutions can become global players with wider scope of businesses, while smaller institutions strengthen their ties with the community to support local businesses, and provide better services to low-income households. As for the household debt problem, a phased approach would be effective by making pre-restructuring efforts before writing off debts. If economic recession prolongs, it will become harder for individual financial firms to deal with deteriorating debts, and a variety of corporate workout programs, once implemented at previous crisis, might be positively considered. To ensure full functioning of the market to serve financial needs of low-income class, long-term policies should be formulated to foster community-based institutions and strengthen relationship banking. Simultaneously, financial firms should emphasize risk management amid prolonged recession and low interest rate environment, and adjust asset management by increasing capital buffer, generating non-interest income and providing less risky products for the elderly consumers. Meanwhile, supervisory authority should endeavor to keep their policies consistent, while maintaining its independence and autonomy.

The 2008 global financial crisis has transformed the paradigm of the global finance. Previously the waves of neo-liberalism swept the industry represented by deregulation and intense competition as businesses grew larger in scale and diversify areas of businesses. However, the trend began to reverse, replaced by a new set of market rules and regulations that emphasized stronger regulation, fair competition and consumer protection. In this period of transition, the domestic market has mid-to-long term tasks in regard to the scope of market intervention by the government, equality and balance between suppliers and consumers of financial services, and the role of social welfare and finance. Against this background, this study explores newly emerging tasks in the domestic financial industry and their future directions.

Changing Financial Market Conditions

The global financial crisis was triggered by a massive deterioration of sub-prime mortgage loans in the U.S; it spread to Europe and spilled over to emerging markets, and precipitated economic recessions around the world. This time, the financial crisis severely eroded fiscal conditions of the affected countries, evolving into full-scale economic crisis. As a result, countries were forced to resort to monetary and credit expansion to spur the economic recovery. Thus, countries lowered interest rates near to zero and broadly implemented quantitative easing. So far, inflation has not occurred yet, but liquidities are liberally flowing into emerging markets, seeking profits and creating bubbles in the securities markets and increasing exchange rate volatility.

Korea is no exception in this regard. A considerable amount of foreign capital is flowing into the country, often for speculation in stock and bond markets. The economic growth rate took a nosedive and the corporate profits are deteriorating, and additional shocks from the fiscal crises of the US and Europe might cause a capital flight, which may lead to a spike in exchange rate and credit crunch.

Confounding the problem is the unfavorable economic conditions in the domestic market. In 2012, the economic growth rate was in the low 2%-range, and it is unlikely to go over 3% this year. As income contracts in both household and corporate sectors, liquidity shortage might grow worse; in turn, financial institutions and investors would step up risk management, towards a more conservative direction, and their role as financial intermediary might shrink further. At the same time, demand for financial firms' social contribution rises, and their capital buffer would grow weaker with lower service fees, making them vulnerable to external shocks.

Tasks of Domestic Financial Industry

This year, the tasks of Korean financial industry would not be so different from what had to be fought last year: mounting household debts, financial soundness of corporations, extending financial service to low-income class, risk management, and revising the framework for financial consumer protection.

First of all, the household debts began to rise sharply in the mid-2000s, and their ratio to disposable income rose over 130% in 2006, sending a warning signal. The ratio continues to grow faster than nominal GDP or consumption, emerging as a primary issue to be dealt with. The average delinquency ratio of mortgage loans rose over 1% and 5% for banks and non-banking financial institutions, respectively, and house prices continue to fall. As the pool of properties to be auctioned increases fast, the auction clearance rate has fallen to the worrisome level of mid-70% range. These are especially visible in the non-banking sector, among the self-employed and multiple loan borrowers with poor credit status. At this point, the household debt problem has not visibly eroded soundness of financial institutions yet as they manage them internally. However, if the problem exacerbates further and the auction clearance rate falls below the average LTV of the non-banking sector (70%), the market might slump further. A large number of people might default, possibly leading to systemic risks across the financial market.

Next, as the economic recessions become protracted, many businesses are deteriorating, and a series of defaults might undermine financial soundness, and cause another type of systemic risks. Recently, the delinquency rate of new loans to the SMEs rose near to 3%, and a quarter of listed companies cannot make interest payment with operating profits. Except for a few conglomerates, most businesses are suffering hard. Accordingly, financial institutions are becoming more conservative and reluctant in extending loans to small businesses, and often refuse to roll over the loans. Reflecting this, the market for corporate bonds is growing polarized; in 2012, only 0.1% of corporate bonds was issued by SMEs. And, among the corporate bonds that reach maturity this year, more than half are grade A or lower, its amount reaching almost KRW20 trillion. If the economic recessions continues much longer, corporate loans might deteriorate en masse, and cause liquidity crunches.

Third, lack of financial services to low-income class is another issue to tackle. Since the Asian currency crisis, banks significantly expanded household loans, blurring the boundary with non-banking deposit-taking institutions. With the implementation of the Basel regulations, risk management grew more important and collateral requirements stricter. As non-securitized loans to low-income people began to shrink, the void was filled by private lenders, spawning concerns over exorbitantly high interest rates and illegal practice of collection. To resolve this, various policies have been implemented, but they are mostly temporary. In the long term, the market will have to be reshaped to accommodate the needs of poor people with limited access to funding.

Fourth, if the low interest rate environment persists, financial institutions would grow more conservative to avert risks, and their role as financial intermediary would weaken. As the loan-to-deposit ratio falls, financial institutions are redoubling their efforts to deal with deteriorating loans. Also, the slump in the stock market shrinks investment in securities, curtailing operating profit of securities firms. The reverse margin problem would hurt business of insurers as well. Financial firms' crisis-management capacities might decline amid falling profits and rising demand for social contributions. For this reason, it will be important to examine the shock-absorbing ability of financial firms in advance, in preparation for possible market shocks.

Lastly, the system to protect financial consumers and the framework for financial supervision will have to be revised. Since the 2008 global financial crisis, consumer protection has emerged as one pillar of financial supervision along with financial soundness. Meanwhile, criticism over the present financial supervisory system rose, especially fueled by the savings banks scandal, which exposed the vulnerability of the current mechanism. Also of significance is reorganizing the system and management of financial policy-formulating bodies. They should be able to flexibly respond to changing policies. It has been repeatedly discussed to eliminate blind spots in providing support and enhance efficiency as comparable institutions in advanced countries have done so.

Redefining Role of Finance

Now the global financial trend is shifting from the waves of deregulation and unlimited competition to a new paradigm of equality and fair competition. Korea should make harder efforts as it lacks financial institutions of global caliber. In the meantime, financial institutions will have to be treated different by their size. Large-sized firms will continue to expand their volume and diversify areas of business, building a foundation to be a global player, while smaller firms focus on supporting local firms and venture businesses, and serve the needs of household sector and the community.

To this end, household debt issue needs a cautious, step-by-step approach. The important considerations are whether financial institutions are capable of absorbing bad debts in the household sector, and the price movement of auctioned properties as a result of non-performing mortgage loans. If the bad debts are too much to be absorbed by financial institutions or the auction clearance rate falls below the LTV ratio of the non-banking sector, the market will perceive them as negative sign and systemic risks would rise. To avoid this, preemptive measures should be taken. First of all, rescheduling for payment of risky mortgage loans should be positively considered. This will include extending their maturity, for example, to ten years, and charging increasingly higher interest rates with time. Maintaining the same present value of loan before and after the rescheduling would help deter moral hazard. Loans may be partially written off for low-income class such as basic livelihood security recipients. Such pre-workout efforts would help turn around bad debts to performing loans, reducing a pool of properties sold in auction. The primary task of financial institutions is risk management and ensuring financial soundness. As such, they will have to take initiatives in risk sharing and resolution of household debt problem. If the situation does not improve much, the next step would be to selectively write off debts, which should be left as a last resort.

Secondly, corporate workout programs that were used in the past crises may be revived in case individual financial institutions cannot deal with deteriorating financial soundness of companies. The scheme to implement a workout regime on companies may be replicated by the 'fast track' program that was designed to relieve liquidity shortage of SMEs. Other conceivable options could be extending guarantees to the SMEs, and reviving tax benefits for products such as bond market stabilization funds, high yield funds, and expedite a takeover process of corporate bonds.

Thirdly, long-term policies should be devised to foster community-based relationship banking to expand financial services for low-income class. For consumers with poor credit status (credit level 5 or lower), credit analysis should focus on qualitative, rather than quantitative, aspects based on personal data compiled over a long period of time. To do so, it will be important to promote best practices, disclose related data and hold meetings to share information. To promote small-sum lending, it will be desirable to assign a certain proportion of loans for low-income consumers. Another possible consideration could be establishing 'Public Corporation for Low-income Class [tentative]' to provide one-stop financial services, while ensuring efficiency and sustainability of its management.

Fourthly, in preparation for drawn-out recessions and persistent low interest rates, financial institutions will have to reconsider their business strategies. It will be effective to secure sufficient capital buffer, through capital increase for instance, to undertake household debt restructuring and corporate workout. Since banks' NIM is declining, banks will have to change the pattern of asset management and seek new profit sources by generating non-interest profits and developing low-interest products for the elderly consumers.

And finally, financial firms need to put together a guideline on consumer protection throughout the stages of product design, sales and follow-up services, and monitor consumer activities. This will call for independence of an agency in charge of protecting and monitoring consumers. There is no 'one-size-fits-all' solution when it comes to financial supervision, and thus, keeping consistency in policies and monitoring activities would be essential. Noting that advanced countries oversee and manage policy finance bodies through a centralized channel, it is an urgent issue in Korea to follow suit and adopt an integrated framework, for example, in form of a holding company.