Special Comment

Moody's Global
Banking

February 2009

# Banks Dependent on Government Foreign Currency Resources for Support:

Korea – A Case in Point


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## Summary

Over the past few months, the Korean banks have come to rely more and more heavily upon the Korean government to provide them with foreign currency to meet their obligations. Therefore, Moody's believes the banks' foreign currency ratings may need to be better aligned, or even capped, by the Korean government's foreign currency debt rating.

The Korean banks' difficulty to refinance their foreign currency debt over the past several months highlights a side-effect of the current financial crisis not typical of past crises. The persistent global dollar shortage in the capital markets and increased investor wariness has been particularly challenging for the Korean and other banking systems that routinely fund a material portion of system loans with offshore foreign currency borrowings.

The Korean government has very substantial ability to provide its banks with local currency liquidity and capital support. It could, as a fiat money monetary regime, print money in order to support its banks. In fact, Moody's believes the Korean government would be willing to do so, if it were required to support systemically important banks. But like all countries, Korea's foreign currency reserves are finite. Furthermore, many foreign currency inflows and outflows are not within the government's control.


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## In General: Moody's JDA and foreign currency obligations

Moody's JDA (Joint-Default Analysis) is used to incorporate systemic support in bank ratings and reflects the benefits of government support in protecting bank depositors. However, the methodology's assessment of government support is heavily based upon a national government's ability to create local currency liquidity. As noted in our March 2007, *Incorporation of Joint-Default analysis into Moody's Bank Ratings: A Refined Methodology,* "Bank creditors look to the national government as a support provider, not in its capacity as a debtor (as measured by its government bond rating), but in its capacity to create liquidity for the benefit of a bank's depositors. This capacity is a function of the monetary regime (i.e., fiat money versus regimes that limit money creation)."

But, governments can not print foreign currency.

The ability of governments to print money can only ensure that banks have sufficient local currency liquidity to purchase foreign currency when they need to. It cannot guarantee that either the international markets or the country's central bank will be willing and able to purchase Korean won or other local currencies in exchange for foreign currency.

That ability is, we believe, a function of their government's capacity to honor its own foreign currency debt and can therefore be measured by the government's foreign currency debt rating.

Therefore, Moody's believes that in applying our JDA methodology it is important that we also consider the possibility that a government's ability to support systemically important banks in local currency may be materially greater than that government's ability to support those banks foreign currency needs, particularly when those banks have large amounts of short-term foreign currency obligations relative to the country's foreign currency resources. In those circumstances, banks' foreign currency ratings may need to be better aligned, or even capped, by the supporting government's foreign currency debt rating. Exceptions to such a cap could be considered for banks that have other foreign currency resources to meet their own obligations.

The circumstances that warrant aligning bank foreign currency ratings with the government's foreign currency debt ratings may most often arise at a time of systemic stress. However, Moody's would also consider the following factors, to determine whether this adjustment is necessary:

1. Material dependence of the banking system on offshore foreign currency funding,
2. Banking system foreign currency liabilities that represent large portions of government foreign currency assets and cash flow, and
3. Total calls (bank, non-bank, and government; actual and contingent) on the government's foreign currency resources, especially in the coming 12 months, that could consume the vast majority of those resources. (as measure by Moody's External Vulnerability Indicator and other ratios)

## Local currency obligations would be largely unaffected

Moody's notes that concerns over a government's finite ability to provide foreign currency denominated support, in no way detracts from a government's ability to provide very large amounts of local currency support. Therefore, local currency deposit ratings can continue to benefit from the government's substantial ability to provide local currency liquidity and/or capital support. Local currency debt obligations could be expected to also remain unaffected by constraints on foreign currency support.

JDA remains key to Moody's approach to incorporating systemic and other support in bank ratings.

However, Moody's would need to analyze this on a case by case basis as a bank's default on a foreign currency obligation could lead to a technical cross default on a local currency obligation. Therefore Moody's would analyze the gap between a bank's foreign currency and local currency ratings and the specific circumstances in each case to determine whether a rating cap on the foreign currency obligations would also impact the local currency obligations and ratings.

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## The Korean Case: Rationale

As the current crisis has demonstrated, there may be times when governments need foreign currency resources to support their banks as well as local currency resources. Korea is such a case. The banking system plainly meets all three of the criteria described above, despite the banks' relatively strong capital adequacy and asset quality measures.

1. Korea's major banks source a material portion (10-12%) of their total funding in foreign currency from offshore capital markets. Furthermore, the duration of the banks' foreign currency funding continued to shorten over the past year.
2. External banking sector short-term debt was about $159 billion at the end of September 2008, equal to more than 80% of Korea's total short-term debt. Even reduced by the $94 billion that is owed by the Korean branches of foreign banks, the domestic banking system still accounts for 34% of Korea's short-term debt. The foreign currency to repay the branch obligations will come from those branches' head offices and not the Korean government. But, given the global pull-back in foreign lending, not all those obligations will be refinanced and the difference will be a net outflow of foreign currency from Korea.
3. Despite Korea's US$201 billion in official foreign currency reserves at year-end 2008, Korea' External Vulnerability Ratio is estimated to have approached the 100% level that indicates considerable strain on the country's ability to meet current obligations. Short-term foreign currency liquidity is, however, temporarily relieved by about a total of $76 billion in bilateral currency swap arrangements extended to the Bank of Korea from the US Federal Reserve in October and from the Bank of Japan and the People's Bank of China in December. Korea is using the Fed's swap line and Korea's banks have been among those bidding for availability.

Therefore, Moody's placed the ratings of all Korean banks having foreign currency debt rated above the country's foreign currency bond rating on review for possible downgrade on January 15, 2009. On February 9, 2009, having found that the banks' own liquid foreign currency resources were not large enough to make them self-sufficient, Moody's capped ratings on those banks' foreign currency debt at the government's A2 foreign currency debt ratings.

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Report Number: 114127

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