Housing Finance in Korea: Recent Trends and Future Prospects

by Kyung-Hwan Kim

A well-functioning housing finance system serves as a lynch-pin connecting the housing sector with the financial sector. Until recently, Korea's housing finance sector has been utilized as an instrument of national housing policy while the basic market principles governing resource mobilization and its allocation were repressed. It was routinely claimed that long-term housing loans should be provided at below-market interest rates to be affordable. Such a policy stance and the public perception were not conducive to the development of a market-based housing finance system. Instead, the country's housing finance system remained fragmented and detached from the rest of the financial system, which itself was heavily regulated. The combination of inadequate housing finance and rigid systems governing the supply of developable land and urban housing was responsible for the country's high and rapidly rising housing prices (Kim 1993).

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THE CHANGING ENVIRONMENT FOR HOUSING MARKETS AND HOUSING FINANCE

Korea's housing and housing finance sectors are going through a major set of changes. Some of the changes were introduced as an integral part of the government policy towards financial liberalization and deregulation of the housing sector. Interest-rate regulation has been lifted, and the price control on new apartments was removed outside of Seoul, the capital city, and the surrounding region.

Other measures undertaken by the government to deal with the problems of unsold apartments caused by the recent slowdown of the housing market and the mismatch between supply and demand also had an impact on housing finance. Included in these measures were concessional loans provided through the National Housing Fund to those purchasing small-sized, unsold apartments and a temporary tax break on the interest payment on such loans. A major reason for granting business permits to mortgage companies in 1996 was to alleviate the financial difficulties experienced by homebuilders.

Interest-Rate Deregulation

One of the most important changes, with far-reaching implications for the entire financial sector, was a series of interest-rate deregulations which started in 1991. It was completed in July 1997 when the government liberalized the interest rates on short-term savings deposits at banks, commercial papers of less than 10 million won ($1= 900 won) and savings at investment trust companies. As a result, market interest rates apply to 92% of total financial deposits and only the interest rate on checking deposits remains regulated.

Together with interest-rate deregulation, government allowed all banks to issue three-year and longer term debentures within the limit of 50% of their net worth.[1] Government also softened the regulation which requires some financial institutions to lend a certain portion of their funds to small- and medium-sized industries.[2] All these measures will intensify market-based competition among financial institutions for funds as well as for customers.

Importance of Privatization

Privatization of the Korea Housing Bank (KHB), which had dominated the housing finance sector for the past three decades, is going to have a direct impact on the housing finance market. The process of privatization started with the 1995 amendment of the Korea Housing Bank Act which stipulated that government share holding be at least 50% of total capital. Subsequently, the government lowered its share of KHB from 95.6% to 46.8% in February 1996.

The KHB Act was repealed in August 1997, and the bank was transformed into a commercial bank, called Housing and Commercial Bank (H&CB). Earlier this year, H&CB issued depository receipts for overseas investors and the government sold some of its shares abroad. Consequently, foreigners have become the largest shareholder, accounting for 47.7% of the paid in capital of 273 billion won ($300 million), while government holds 26.3%, employees 8.6% and the remaining 17.4% is held by various interests. The bank plans to stay as a major force in the housing finance business and has committed to allocating 70% of its portfolio for mortgage lending, a share not much lower than the 80% mandated minimum prior to privatization.

Some regulations on the disbursement of housing loans were also removed during recent years. H&CB now extends its loan products to dwellings more than 10 years of age and to customers who have not subscribed to savings schemes with the bank. This product is offered at a higher interest rate than the conventional KHB loans made available to customers with a qualifying savings record. Commercial banks are allowed to make long-term loans with a term exceeding 10 years. However, banks continued to be prohibited from lending to dwelling units larger than 100 square meters of net floor space or to finance land purchases by developers.

HOUSING FINANCE MARKET TRENDS

The volume of funds flowing into the housing finance sector grew steadily in the 1990s. As shown in Table 1, the volume of new housing credit doubled from 5,514 billion won ($7.7 billion) to 10,946 billion Won ($13.3 billion) between 1990 and 1996. Total mortgage loans outstanding increased from 16,391 billion won ($22.9 billion) to 44,971 billion won ($53.3 billion) during the same period. Total mortgage debt outstanding was equivalent to 9.1% of GDP in 1990, but the figure jumped to 11.5% by 1996. However, the ratio between housing credit and housing investment fell from 37.8% to 34.1%. The average loan-to-value ratio (LTV) of H&CB loans was even lower, standing at 24.8% in 1996 (*C&B 1996*, p.28).[3]

Table 1. Key Indicators of Housing and Housing Finance

	1990	*1993*	*1996*
House price to income ratio	9.0	6.9	5.2
House price appreciation (% p.a.)	21.0	−2.9	1.5
Mortgage debt outstanding (billion won)[1]	16,391	30,376	44,971
Supply of housing credit (billion won)	5,514	6,927	10,946
Housing credit to housing investment (%)	37.8	30.5	34.1
Mortgage debt to GDP (%)	9.1	11.4	11.5
Mortgage rate to bond rate difference (% pts.)[2]	−7.00~-4.75	−1.21~0.79	−1.07~2.43

[1] The exchange rate was $1=716.4 won in 1990, 808.1 in 1993 and 844.2 in 1996.
[2] The difference between the highest rate charged by private sector lenders and the three-year, corporate-bond yield.

Source: Ministry of Construction and Transport, Housing and Commercial Bank

One of the contributory factors to the expansion of the housing finance sector was the entry of a new class of player. Ten mortgage companies started mortgage lending operations and 21 installment credit companies were allowed to make home loans in 1996. They mobilize resources through borrowing from merchant banks (essentially short-term credit institutions) as well as from the capital market by issuing debentures. They currently offer loans at market rates to finance purchases of new dwellings, but they are expected to lend to finance the purchase of existing houses in the near future.

In addition, their loans are not linked to contractual savings, unlike those provided by the H&CB. Also, they finance houses up to 135 square meters of net floor space, instead of the 100 square meters limit which applies to the loans from H&CB or commercial banks.[4,5] During the first year of operation, the mortgage companies and installment credit companies together originated 1,148 billion won ($1.4 billion) in mortgages, equivalent to 10.3% of the aggregate supply of housing credit. Their remarkable success proves the proposition that timely access to credit is more important than interest rates (Kim 1995), and that there is substantial demand for loans to finance large dwelling which is unmet by loans from banks.

Home Loan Business Expands

With the arrival of the mortgage companies and installment credit companies, the volume of home loan business has substantially expanded. The total amount of net lending of home loans increased by 22.4% in 1996. At the same time, the market shares of the housing loan originators have changed markedly. According to Table 2, KHB accounted for 33.6% of all housing credit in 1990, but its share fell to 24.3% in 1996 after reaching a peak at 39.1% in 1993.

Likewise, the share of NHF dropped from 48.3% to 41.7% between 1990 and 1993 before it bounced back to 42.6% in 1996. Life insurance companies' market share shrank

Table 2. Market Share of New Housing Credit (%)

	1990	*1993*	*1996*	*1997 (first half)*
Housing & Commercial Bank	33.6	39.1	24.3	27.9
Citizens National Bank	6.0	9.0	4.6	5.6
Life insurance companies	7.8	7.5	5.6	4.5
Commercial banks	3.5	0.5	9.5	10.5
Mortgage companies & installment credit companies			10.3	25.3
National Housing Fund	48.3	41.7	42.6	23.9
Federation of Agricultural Cooperatives	0.8	1.9	3.2	2.4

Source: Housing and Commercial Bank, Ministry of Finance and Economy

from 7.8% to 5.6%, whereas commercial banks picked up a substantial portion of the market during the same period. The mortgage companies and the installment credit companies continue to impress the market in 1997. During the first half of 1997, they accounted for 25.3% of total supply of new housing credit, closely chasing the H&CB's share of 27.9%.

Allocation of housing loans has become more diverse in recent years. In 1990, 77% of housing loans from KHB were provided to finance new housing, whereas less than 3% went to finance purchases of existing units and 21% for rental housing.[6] By 1996, the share of new home purchases went down to 60% while that of existing units and rental housing rose to 15% and 25%, respectively. The distribution of loan terms and dwelling size also widened. Twenty-year loans are still most popular, but the share dropped from 84% to 71% over the same period.[7] The average size of dwelling financed with loans from H&C and that financed by NHB are more distinctively different from each other than before.

PROSPECTS FOR THE FUTURE AND LOOMING POLICY ISSUES

Major changes taking place in Korea will speed up the development of market-based housing finance. The ongoing financial sector reform aims at promoting competition among financial institutions by removing regulations over the types of business each of them can be engaged in and also the various entry barriers. In the area of housing finance, the mortgage business is now open for all "loans-specialized" financial institutions which do not take deposits from the general public, such as lease companies and installment credit companies, in addition to existing players.

As a result, the market structure of housing finance will become more broad-based. In the emerging new structure, commercial banks, insurance companies and mortgage companies will enjoy larger market shares than they did before. In the past, commercial banks lent mostly to business firms, but the demand for bank loans by those corporations with good credit rating will decrease as they seek to mobilize more funds from the capital market.

On the other hand, commercial banks will have more funds available for lending because the mandatory lending requirement to small- and medium-sized industries was softened at the same time when they are allowed to issue debentures. As a result, these banks are likely to expand their housing loan portfolio. Insurance companies used to offer home loans predominantly to subscribers of insurance products, but they are now given greater flexibility in deciding to whom to lend their money. In addition, foreign banks have the potential to seize a share of the market.

Battle for Market Share

H&CB will probably lose some of its market. One reason is the rise in the cost of their funds. The bank has been able to mobilize low-cost funds from contractual savings granting eligibility for the purchase of new apartments at regulated prices. But the volume of these savings has been declining since 1991, the last peak in housing prices. It was further exacerbated by the shrinking premium associated with the price control on new apartments.

The trend is likely to continue because the price control has been lifted outside of Seoul and the Capital Region, and the remaining control is expected to be repealed sooner or later. As a result, H&CB will lose a major edge in resource mobilization relative to its competitors. The bank will also need to increase capital to maintain its high credit rating and competitiveness, as well as meeting the more stringent standard for the BIS-Capital Adequacy Ratio (Lee 1997). Finally, H&C will have to upgrade its marketing capacities to maintain their market share in a more competitive environment.

Whether or not the mortgage companies and installment credit companies will be able to maintain their current market share is an open question. They have quickly established their niche by specializing in providing bridging finance to "chonsei" tenants who have signed contracts to purchase new apartments in installments and face cash flow constraints because their equity is tied up in a deposit with their landlord. They were given an advantage of financing large dwelling units on which H&CB and commercial banks are not allowed to lend. Speedy processing of loan applications, diversity in the line of loan products, credit enhancement schemes and effective marketing strategies were important ingredients for success.

By contrast, they are handicapped with respect to the branch network and resource mobilization. Because of low credit rating, they have difficulties raising revenue by issuing long-term bonds. As a result, they rely heavily on short-term borrowing from nonbank financial institutions and hence carry large liquidity risks. Since their cost of funds is higher than H&CB or commercial banks, their loan products may become less attractive once these competitors are allowed to provide loans to their current clientele.

An Expanded Resource Base

The resource base of housing finance institutions is expected to expand and be more diversified. Resource mobilization will be more closely linked to the capital markets since all commercial banks and mortgage companies are allowed to issue debentures. The capital market will become an even more important vehicle for mobilizing resources for housing finance if some form of the secondary mortgage market is created in 1998 as announced by the government.

The climate conducive to the introduction of the secondary mortgage market is ripening as more loans are made at market rates. According to Table 1, the interest rate on housing loans charged by the private sector institutions was 4.75 to 7.00 points below the corporate bond rate in 1990. Now the lending rate on some housing loans stands 2.43 points above the bond yield. Although a substantial fraction of housing loans is still offered at below the bond rate, the gap is much narrower than before.

However, the country's relatively underdeveloped long-term bond market may limit the volume and the level of sophistication of secondary mortgage market operations. The aggregate value of bonds listed on the capital market increased rapidly from 51 trillion won ($71.2 billion) to 176 trillion won ($208.5 billion) between 1990 and 1996. However, the current size of the bond market is still small relative to the size of the economy. The ratio between aggregate value of bonds and GDP is about 0.45, much smaller than that of Japan (0.86) or U.S. (1.38). Moreover, the market for bonds and bank debentures is dominated by short-term bonds of three years of maturity, although longer term government bonds started appearing on the market in recent years.

As the size of the bond market continues to grow and the share of long-term bonds increases, the scope of the secondary mortgage market will expand and the resource base of housing finance institutions will broaden, especially for mortgage companies. Hopefully, the introduction of the secondary mortgage market will create the new demand for long-term bonds as well as itself relying on the bond market to mobilize funds.

No Secondary Market Plan Exists

At this point, a detailed blueprint for the secondary mortgage market is yet to be drawn up. The government has announced its plan to promulgate special legislation next year to provide a legal basis for some form of secondary mortgage market operations. This special legislation will have to have provisions concerning the notification to the borrower of the transfer of the mortgage and the registration of the transfer, as well as the issuing of mortgage-backed bonds.

Whether or not an intermediary will be necessary is another key question to be addressed in the design of the secondary mortgage market. At this stage, the relatively simple model in which an intermediary purchases mortgages from originators and holds them appears to be most feasible.[8] Also credit enhancement mechanisms should be carefully thought through.

SOME FINAL REMARKS

This short article intended to provide an overview of the recent trends in and future prospects for Korea's housing finance sector, with an emphasis on the private sector institutions and the new environment conditioning their operation. The emerging future will be characterized by the development of a market-based housing finance system. The new system will be much better suited to responding to changing demand for housing. The facilitating role of market-based housing finance will be further boosted when and if the supply of developable land is made more flexible.

The public sector housing finance is also at a crossroad. A short-term issue concerns the administration of the National Housing Fund (NHF) operations which KHB has been in charge of on a commission base. Now that Housing and Commercial Bank (H&CB) is given the status of a commercial bank, it is difficult to justify the bank's role as a sole managing agent of NHF and the monopolistic administrator of the process of selecting purchasers of apartments sold at a discount. Consequently, these functions will have to be shared with other willing financial institutions, including commercial banks.

A more fundamental policy issue is redefining the role of the public sector in housing finance. So far NHF has served as an integral component of government housing policy to promote homeownership of middle- and moderate-income households by offering interest rate subsidies. NHF relies quite heavily upon contract savings and proceeds of special bonds sold on a mandatory basis, while the contribution from the national treasury is minimal.

Since these sources are not very stable and sustainable, the room for further expansion of the Fund seems to be limited. In light of this, it is time to redefine the mode and scope of government intervention in the public sector housing finance and restructure the current system accordingly. The potential role of the public sector as the facilitator of the secondary mortgage market and that of the last resort of housing finance could be carefully evaluated.

Another important question is whether the current policy of interest subsidies should continue. In the longer term, interest-rate subsidies ought to be replaced by one-off capital grants to qualifying households to be combined with market-rate loans or rental subsidies to raise the rent-paying capacity of low-income households.

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NOTES

[1] The Banking Act allows commercial banks to issue bonds up to 500% of their net worth. In practice, the limit is approved by the Monetary Board.

[2] The Small and Medium Industries Bank was required to allocate at least 90% of new funds raised to the small industries, but the share was lowered to 80%. The regulation required local banks (headquartered outside of Seoul) to allocate 70% or more of new lending to small industries, but the ratio was cut back to 60%. Housing and Commercial Bank had not been subjected to the regulation, and hence the policy change has no impact on the bank. Other commercial banks continue to be required to channel 45% of new loans to small industries as before. However, the declining demand for bank loans by businesses is expected to induce the banks to expand consumer credit in general and housing loans in particular.

[3] The vast majority of the loans (85% of loans for home purchases) were made to finance new dwellings.

[4] There are several types of contractual savings schemes. The first type is a scheme under which a household must deposit a certain amount for a specified period of time before becoming eligible to bid for a new apartment offered at a discount. The interest rate on such deposit is 8.5%, a bit lower than that on a one-year time deposit which is 9% per annum. Once the household is selected to purchase an apartment, the deposit can be withdrawn or kept as a regular time deposit with no further privileges. The Housing and Commercial Bank has about 750,000 accounts of this type, a substantial decline from its peak of 1 million in 1991. The second type is the standard contractual savings scheme which provides eligibility for housing loans after a specified number of installments has been made. The deposit rate varies with duration between 8.5% and 9%, while the lending rate is around 11%. There are about 4.8 million accounts. The third type is a combination of the two types, and there are about 860,000 accounts. Although the lending rate is higher than the deposit rate in all these products, C & B incurs a small amount of loss from housing loan operation because the volume of loans is greater than the deposits generated, and additional funds need to be raised at market rates. However, the share of funds raised through contractual savings has declined substantially since 1990 (Lee, J. 1997).

[5] According to the 1995 Population and Housing Census, the average gross floor space of existing urban dwelling was 80.5 square meters. The average size of new housing is larger. Among the new apartments supplied during the 1993–1996 period, 41% of total supply was about 60 square meters in net floor space (about 70 sq. meters in gross floor space), 33% was about 85 sq. meters (about 100 sq. meters in gross floor space), 3% between 85 and 100 sq. meters, and 14% between 100 and 135 sq. meters.

[6] Loans to rental housing are provided towards "Chonsei" deposit. "Chonsei" is a unique rental arrangement widely practiced in Korea. Under this arrangement, the tenant leaves a deposit, as large as 50% of the

value of the house, to the landlord in lieu of monthly rents. The deposit is fully refunded at the end of the contract term. "Chonsei" also serves a function of informal housing finance. One could purchase a house and have it rented for a deposit, which could be combined with his own funds to pay for the purchase price. A recent study by the Korea National Housing Corporation indicates that 20% of the surveyed households have purchased their current houses in this manner. According to the Housing and Commercial Bank's 1996 survey of 700 households living in 13 major cities, the average amount of deposit was 31.95 million won. Another survey of households living in Seoul carried out by the Seoul Development Institute towards the end of 1996 reports that the average deposit was 31.86 million won ($37,740). Since Seoul had 1.3 million "Chonsei" tenants in 1995, the aggregate claim of deposits in Seoul alone would have been 41,418 billion won ($49 billion), equivalent to 92% of total housing loans outstanding in the whole country as of 1996. This represents a great potential for expanding the formal sector housing finance.

[7] The trend is misleading because the decline of the share of 20-year loans is a result of modification of the repayment methods to be applied to the remainder of the terms for the loans originally made on a 20-year term.

[8] This is a model of Fannie Mae in its early years, as well as currently being practiced by the Cagamas of Malaysia.