INSIGHT

Mitigating Household Debt Risks and Fostering Productive Finance

In the Republic of Korea, the government has formulated comprehensive measures to address household debt risks. Photo credit: Korea Institute of Finance.

The Korean government has employed comprehensive policy measures to manage household debt risks.

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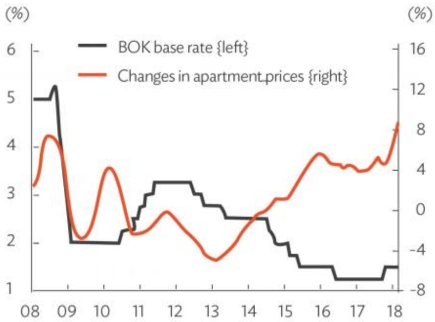
Introduction

As the period of low interest rate environment persisted in the aftermath of the 2008 global financial crisis, housing prices began to rise in 2014, and household debts have grown sharply as a result. Noting that household debts pose a significant threat to the economy, the Korean government employed comprehensive policymeasures to manage household debt risks. They have been effective in slowing down the growth of household debts and increasing a share of fixed-rate, amortized mortgage loans. Meanwhile, the government promotes productive finance?which aims to channel more funds to core areas of Fourth Industrial Revolution, SMEs, and innovative firms?and this is expected to contribute to enhancing social value by creating more jobs and raising household income level.

Analysis

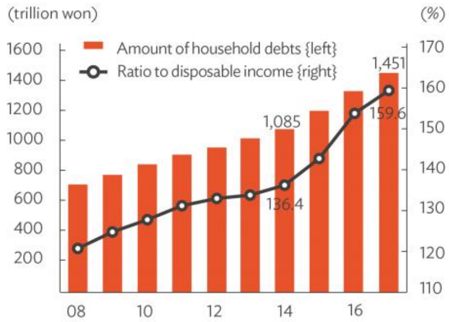
Last year, the Republic of Korea's financial authority unveiled comprehensive measures to address household debt risks, which have become a grave threat to the national economy. Household debts have grown sharply amid a prolonged period of low-interest rate environment?the base rate was around 5% in 2008 and has steadily fallen?except for five hikes between 2010 and 2012?to a historical low of 1.25% by 2017. The growth of household debts was further fueled by government measures to normalize the housing market in 2014, which included eased regulations on the rebuilding of old apartments, simplified application for home purchase, flexible application of capping new apartment prices, and raising the caps of LTV and DTI ratios. These measures led to a sharp increase of housing prices, particularly for apartments in Seoul, and speculative housing demand soared. The amount of household debts rose from 1,085 trillion won in 2014 to 1,451 trillion won in 2017, and the ratio of household debts to disposable income rose steeply from 136.4% to 159.8% over the same period.

Figure 1: Base Rate and Housing Price Increase[1]



Note: 1) For households in Seoul
Source: BOK

Figure 2: Amount of Household Debts and Ratio to Disposable Income[1]



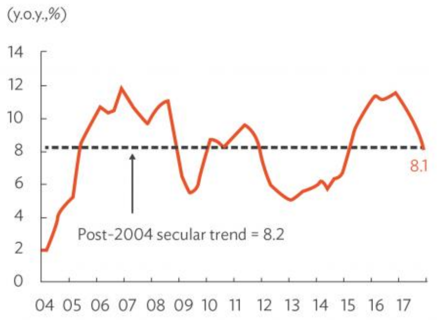
Note: 1) BOK household credit data
2) Ratio to net disposable income
Source: BOK

When household debt increases in line with the economic growth and development of the financial market, it can promote the growth. However, if it grows too fast, it might dampen economic growth and hurt financial market stability. That is, excessive household debts increase repayment burden, limit private-sector consumption growth, and might magnify downward pressure in case of a negative economic shock, thereby delaying a recovery.

Noting these problems, the government unveiled comprehensive measures to address household debt risks in October 2017 that pursue three goals?customized financing for vulnerable borrowers, risk management from the standpoint of total amount of debts, and structural responses?and seven key tasks were identified, including debt restructuring, support for credit rehabilitation, easing repayment burden of delinquent loans, tailored support for small business owners, expansion of low-income financing support center, reforming policy mortgage loans to better serve needs of actual would-be homeowners and low-income borrowers, and revitalizing reverse mortgage and REITs. In the following month, the government adopted measures to improve financial firms' lending review and accordingly introduced new DTI and DSR regulations to better assess borrowers' loan affordability. Further, guidelines on lending review for small business owners were adopted in March this year. Then the financial authority took additional measures to better protect vulnerable borrowers by installing a prewarning system for high-risk borrowers, revising a penalty rate-setting mechanism for delinquent loans, and strengthening protection for borrowers when a security right is exercised.

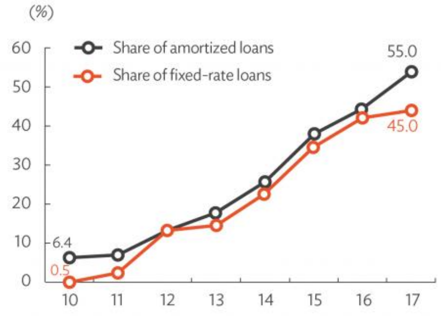
The comprehensive measures on household debt risks have been effective in curbing the growth of household debts and improving their quality. In 2017, the growth rate of household debts was 8.1%, falling below a secular trend of 8.2% since 2004. Also the share of amortized loans?compared to balloon payment loans?and the share of fixed-rate loans have increased, thus mitigating interest rate risks and risks associated with lump-sum repayment at maturity. Still, household debt risks should be closely watched as interest rate rises and housing price rise slows down.

Figure 3: Growth Rate of Household Debts[1]



Note: 1) Household credits
Source: BOK

Figure 4: Share of Fixed-rate Amortized Loans in Banks' Mortgage Loans

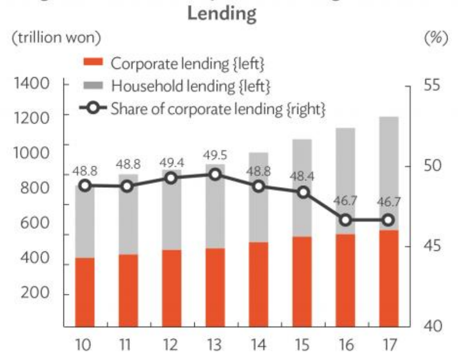


Note: 1) B2017 data are estimates
Source: FSS

Insights

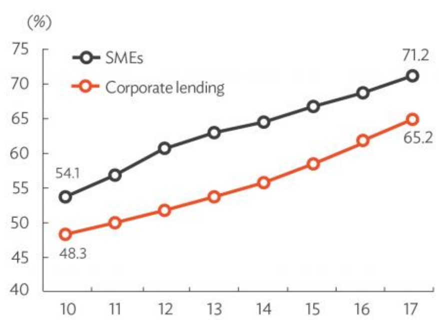
Although heavy liquidity flows to the household sector have slowed down, it is premature to say that financial institutions' intermediary role has been restored. Financial institutions' mission is to facilitate economic growth by efficiently channeling private-sector savings to productive areas, thereby distributing risks and saving transaction costs. However, in practice, ample funds have been channeled to unproductive areas, and banks emphasized securing collaterals more than proper risk evaluation. Since 2014, the share of corporate lending fell sharply in banks' total lending, while the share of collateralized lending has steadily risen since 2010.

Figure 5: Share of Corporate Lending in Banks Lending



Source: FSS

Figure 6: Share of Collateralized Lending in Banks' Corporate Lending



Source: FSS

Recently, growing emphasis is put on productive finance, whose goal is to create an ecosystem for innovative growth, recover an essential role of finance as an intermediary, and strengthen financial support for SMEs. Specifically, efforts are underway to establish an innovative venture fund worth 10 trillion won, support scaling up of innovative venture firms, ban joint surety by public institutions, reform capital regulations on the financial industry, promote tech-financing and asset-based lending, and strengthen the role of policy financing. These efforts are expected to channel more liquidity to flow to core areas of the Fourth Industrial Revolution, SMEs, and innovative firms, and by doing so, a social value would be enhanced with more jobs and higher income level.

References

Korea Institute of Finance website.

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