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Korea: maintaining economic momentum

South Korea remains one of the most diversified and technologically advanced nations. Yet it remains vulnerable to its heavy reliance on exports, limited domestic market and dwindling social safety net, all of which weigh heavily on the country’s continued quest for long-term sustainability.

AS NATIONS AROUND the world step up efforts to restructure their economies, South Korea continues to show signs of sustainable growth. From rubble to riches, the country that just over 60 years ago lay flattened after the Korean war has risen to rival much of the developed world in a staggeringly short time, while managing to circumvent recent global economic gyrations.

The South Korean economy has grown on an average 1.1% quarter-over-quarter basis since the Asian financial crisis, fuelled largely by exports, which account for half of its GDP, a spike in private consumption, facilities investment coupled with robust exports, and the moderate recovery in major countries. The country’s current account registered its largest-ever annual surplus of $70.1 billion at the end of 2013; the previous record was $48.1 billion in 2012.

The Ministry of Strategy and Finance (MOSF) reports that exports rose 2.2% year on year to $138.2 billion in the first quarter this year, a record for a first-quarter figure. Average daily exports and trade volume also rose to new first-quarter highs, at $2.08 billion and $270.8 billion respectively.

Shipments to the EU showed double-digit growth for three consecutive months, thanks to the EU economy and the Korea-EU free trade agreement, surging 16.3% year on year to $13.53 billion. Shipments to Brazil, India, Indonesia, South Africa and Turkey rose 5% to $10.92 billion.

At the end of February, official foreign reserves stood at $351.8 billion, an increase of $25.4 billion since the end of June 2013. Reserves are now more than three times greater than short-term foreign debt, which has fallen from a peak of $189 billion at the...
end of 2008 to $113 billion at the end of 2013.

South Korea’s GDP grew 3.9% year on year in the first quarter of 2014 — the highest rate for the past 11 consecutive quarters — bolstered by private consumption and capital investment. Moreover, the country averaged a 1.71% overall GDP growth rate from 1970 to 2014, an impressive figure compared to other members of the Organization for Economic Cooperation and Development (OECD).

According to the Bank of Korea (BOK), South Korea extended its current surplus streak for the 27th successive month in May this year, while the current account surplus reached $9.3 billion in June, up from $7.12 billion in April.

At the end of February, the Korean won changed hands at a rate of KRW1,067.5 against the US dollar, an appreciation of 7% compared to the end of June 2013.

The OECD forecasts the Korean economy will expand by 4% this year, up from last November’s 3.8% projection. Economic activity accelerated in mid-2013, led by corporate and construction investment, and the OECD expects the economy to grow at around 4% throughout 2014 and 2015, as free trade agreements with the EU, the US, Canada and Australia boost trade efforts.

According to Moody’s Investors Service Global Credit Research report this May, the outlook for the Korean banking system remains stable, reflecting an expectation that economic growth will gradually gain momentum while systemic support remains strong. Bank profitability is low but could improve somewhat in 2015 as policy rates rise. Korea has a strong support system. None of its national and regional banks have been liquidated in the past two decades, even when the banking system faced significant stress after the Asian financial crisis in the late 1990s.

Innovation plan

South Korea’s domestic economy is also showing signs of continued improvement, the BOK reports, aided by recent policy efforts and the government’s three-year innovation plan, a massive KRW4 trillion financial package announced in February that will support establishing IT venture companies.

Yet such projections do not come without foreseeable risks, including the possibility of international financial market instability following the tapering of the US Fed’s quantitative easing and an expansion of the yen’s exchange rate volatility, concerns of a slowdown in Chinese economic activity and upside risks such as an acceleration of growth in the US and the euro area.

Private consumption is expected to grow due to improved income conditions and renewed consumer confidence, yet the debt repayment burden caused by the overhang of household debt and the high level of leasehold deposit prices are two issues that could very well blunt its recovery.

As the global economy shows signs of growth, the Korean economy is also at a turning point. A series of comprehensive measures by President Park Geun-hye’s administration has put the economy back on the road to recovery; however, some argue that the economy is not recovering as fast or as strongly as expected.

“Investment, which has been one of the key drivers of the nation’s economy, continues to falter, raising concerns that the economy has become structurally weaker since the financial crisis,” says Kim Jung-Kwan, economic policy division director at MOSE. “Whether the Korean economy will leap forward or fall into an era of slow growth depends on the government’s policies over the next three to four years.”
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As advanced economies pull back from looser monetary policies, global funds are flowing from emerging to advanced economies, and from bonds to stocks. In the process, uncertainty in the global financial market is rising, led by some vulnerable emerging markets.

“Korea faces several obstacles to growth, the first being slow population growth. Korea’s population is ageing at the fastest rate among the OECD member nations, and the economically active population is expected to decline, beginning in 2017,” Kim asserts. “Large corporate investment used to lead growth in the past, but today investment lags behind growth.”

Inefficiency in the public sector and unfair practices in the private sector are also threatening the economy’s competitive edge. According to the 2013 World Economic Forum (WEF) Global Competitiveness Report, Korea placed 25th in the overall rankings, but ranked only 74th in ‘institutions’ and 78th in ‘labour market efficiency’.

Furthermore, imbalances between sectors are leading to structural vulnerability. The share of services in national output is 60%, which is more than 10 percentage points lower than other major economies such as the US (78.3%), Germany (70.1%) and Japan (70.5%). Household income inequality has been on the rise since the 1997 financial crisis, while the gap between large conglomerates and small businesses in terms of profits, productivity and wages is widening.

Despite lingering concerns, South Korea ranks high in terms of financial viability. In June, it performed strongly against Asia’s seven leading nations in a survey conducted by the Korea Trade-Investment Promotion Agency (KOTRA) to determine the most attractive foreign investment destinations. Korea ranked first overall in terms of social infrastructure, including transportation, logistics, telecommunications and water supply, and came second in terms of market competitiveness, R&D and innovation. The survey was answered by 243 corporations in 21 countries.

Yet the government is aware that Korea’s traditional growth strategy, focused on exports by conglomerates and imports of technology, has run its course. Inequality has gradually increased due to globalization, technical progress, ageing and low public social spending. Korea’s relative poverty rate is now the eighth highest in the OECD. In addition, it ranks visibly lower than the OECD average in six of the 11 categories of the organization’s well-being index.

Moreover, the strategy has led to imbalances between export and domestic demand, manufacturing and services, chaebols and SMEs, and regular and non-regular workers. The government, which took office in 2013, is seeking a new paradigm based on creativity and innovation. The Park administration launched its ‘Creative Economy’ initiative last year; more specific measures have been fleshed out in the broader and more comprehensive three-year plan.

Three-year economic plan

The bulk of South Korea’s economic structure is heavily concentrated around a fraction of the country’s true potential. This poses a serious threat to its long-term stability, contributing to greater inequality by widening wage dispersion in favour of large companies, which account for around two-thirds of exports, and manufacturing.

Earlier this year, the government initiated a series of strategic measures to highlight this issue and overcome the heavy reliance on a small set of industries. President Park has been calling for a “second miracle on the Han River” since she took office in February 2013. The plan is aimed at revitalizing the economy and achieving 4% potential growth, a 70% employment rate and $40,000 per capita GDP, up from $26,000 in 2013.
Based on three key strategies, the government’s revised plan encompasses: a fair and efficient economy (reforming the public sector and expanding the social safety net), growth through innovation (finding new growth engines for the economy), and balance between exports and domestic consumption (to achieve sustainable growth by removing obstacles to domestic competition and providing more employment opportunities for women and young adults).

The first strategy involves reforming the public sector, developing a rule-based market economy and building a strong social safety net. Korea’s public sector has long been plagued by inappropriate practices and low productivity, due to lax management, high debt ratios and various types of rent-seeking behaviour.

By introducing competition among public institutions, as well as in the private sector, the new measures will boost public institutions’ productivity. State-owned enterprises will be required to reduce their debt-to-equity ratios from an average 239% in 2013 to 200% in 2017 by streamlining their activities and selling assets. The government also plans to eliminate 600 overlapping government programmes during the next three years.

The second strategy envisages a dynamic economy fuelled by innovation, reinforcing the government’s 2013 initiative to foster a creative economy by developing creative industries, investing in the future and expanding Korea’s presence in overseas markets.

Venture businesses and SMEs are the core of a creative economy. To improve the business environment for them, the government will inject KRW4 trillion ($3.9 billion) by 2017. This investment will include start-up funds for young entrepreneurs and angel investment. Venture businesses and start-ups play a key role in commercializing new technology and creating jobs. Korea’s venture capital market is still at a very early stage of development, accounting for less than 1% of SME financing.

In addition to providing tax breaks on capital gains resulting from technology transfers, in an effort to boost trade in intellectual property rights, the government is also to introduce measures to promote exports by smaller firms. At present only 2.7% of SMEs export. Korea has free trade agreements with countries accounting for around 55% of world GDP. That coverage is to be raised to 70%, in part by concluding an agreement with China.

The third strategy is to create a more balanced economy, focusing on boosting domestic demand, improving the investment environment, raising the employment rate and promoting ambitious regulatory reform to jump-start business investment.

The government will promote the creation of 1.5 million jobs for women and 500,000 for young people. To promote female labour force participation, the government will focus on providing flexible childcare services and strengthening financial and legal support for part-time jobs. The government will also cut the tax burden for service industries and increase funding for start-ups.

The Bank of Korea will also increase its support for a financial intermediary programme for self-employed small business owners, and the scope of support will be extended to cover borrowers of loans with a 15% or more interest rates, down from the current 20%.

Boosting the services industry could very well help Park lower the economy’s dependence on exports and lift growth potential to her target of 4% over the next three years as she tries to reduce the dominance of conglomerates to enable smaller companies to thrive and prosper.

Shaking up the service sector, which is dominated by small companies, could be just the boost Korea needs. Smaller companies lag behind larger ones in productivity due to a lack
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of investment and R&D. R&D spending in Korea was the highest in the OECD, at 4.4% of GDP in 2012, with the business sector accounting for nearly three-quarters of the total.

Easing export reliance
South Korea continues to seek ways of alleviating heavy reliance on exports by developing domestic-oriented sectors. Conglomerates such as Samsung and Hyundai Motors still account for a considerable share of Korean exports. The government has implemented a series of strategic measures to boost domestic demand and promote IT ventures.

“Nowadays Korea’s export-driven economic development policies place a number of constraints on the country’s growth, as they have generated the problem of a chronic imbalance between exports and domestic demand,” says Hong Teak Lim, a portfolio manager in Shinhan’s Investment Consulting Department. “Whereas before the global financial crisis the world economy experienced explosive growth of demand in quantitative terms because of the secular increase in the population structure of the advanced economies, we are now on the threshold of an era of qualitatively-driven demand in response to demographic ageing.”

Double-digit growth in export volume during the past 20 years has made Korea the seventh-largest exporter and 15th largest economy in the world, according to the OECD.

“The Park administration wants to lessen Korea’s reliance on exports and focus more on the domestic economy,” says Hyunju Kang, research fellow with the Korea Capital Market Institute (KCMI). “The policy direction is appropriate. Many Korean economists agree that the disparity that exists between export and domestic sectors is a long-dated issue in Korea.”

Reducing its reliance on exports will make Korea resilient to external shocks. A stronger currency benefits consumers by reducing the price of imported goods, while reducing the international competitiveness of exporters.

“The snag here is that we confront the immediate problem of the massive mismatch between exports and domestic demand,” asserts Lim. “President Park Geun-hye’s second economic team has declared its intention of tackling these questions through counter-measures that include the easing of real estate regulations, calls for the reduction of interest rates and fiscal expansion policies, clearing away regulatory red tape, and policies to support corporate investment and the distribution as dividends of cash reserves. It is also setting out to revitalize domestic demand.”

Relaxing the debt-to-income and loan-to-value ratios, deregulating the service sector, emphasizing the role of financial sectors in supporting the real economy and inducing companies to provide shareholders with greater dividends in the hope of positive wealth effects are some of the key issues in the government’s agenda in righting the course of Korea’s long-term economic forecast.

“Accordingly, there is expected to be intensifying competition in basic technologies that have potential export applications” says Lim. “From this it follows that those countries and firms that are unable to keep up will be driven out and, undoubtedly, the importance of domestic demand will become larger in every country. In this regard, Korea is suffering from the worsening depression of domestic demand arising from the sharp rise in household debt that is largely centred on housing loans. In comparison to lacklustre domestic demand, exports have registered buoyant growth as economic activity picks up around the world and the country’s current account surplus is at record levels.”

Some foreign exchange market participants speculate that the government may seem to be leaning toward allowing the Korean won to appreciate gradually, although smoothing operations will be conducted in the case of greater volatility in FX market.

Korea’s booming tech industry isn’t immune to economic fluctuations either. Samsung, the world’s biggest maker of mobile phones, has been showing signs of competitive pressure. The tech behemoth attached a “supplementary reference material” document to its earnings guidance release for the second quarter this year to minimize investor concerns about the 24% drop in second-quarter profits from last year. This is the third straight quarter its operating profit has fallen.

Samsung also bore the brunt of an overall slowdown in smartphone market growth and saw increased competition in both Chinese and European markets. Weaker demand in the second quarter also led to increased inventory in Europe, where Samsung has a 40% market share.

Quarterly revenues grew from KRW52.87 trillion to KRW53.68 trillion ($52.04 billion) year on year, but profits dipped to KRW8.49 trillion, from KRW8.78 trillion in Q1 2013.

The earnings forecast reflects the strong Korean currency throughout the second quarter as it appreciated against the dollar, euro and most emerging market currencies. The won rose more than 11% against the US dollar and nearly 7% against the euro between July 2013 and end of June this year. A stronger currency hurts profits of Korea’s conglomerates, which rely heavily on exports, when they repatriate their foreign earnings.

While the market for smartphones appears to be flat, the mobile division is still profitable. Samsung’s cash reserves increased to nearly $60 billion this quarter, up from around $43 billion this time last year.

Yet competition is getting fiercer with companies targeting the market for high-volume, low-margin handsets. Many in the industry argue that profit margins are likely to fall even further and fear that the golden era of high-end smartphones is over.

Ferry disaster hits leisure industry
In May, President Park spearheaded a joint public-private emergency meeting on the real economy to initiate ways to speed up the private sector recovery and support industries affected by the previous month’s Sewol ferry disaster.

“In this situation the influence of the Sewol disaster is likely to worsen the depressed state of the travel and leisure sectors,” says Lim. “Looking at the impact of the ferry disaster in simple terms of the quantitative effect on the economy, this is likely to remain temporary, but it is likely to be a factor working to
the long-term suppression of domestic demand in that it adds to the psychological factors engendering this as a structural problem in Korea.”

To support travel, transportation and accommodation-related businesses affected by the disaster, the Tourism Promotion and Development Fund will provide upwards of KRW50 billion in loans, at a low interest rate of 2%, with a two-year grace period. Industrial Bank of Korea will lend up to KRW300 million per business, with a total of KRW30 billion made available.

“An incident of this type will mean that recovery could take a long time and currently the second economic policy team of the Park Geun-hye’s government is planning more active economic stimulation measures including expansionary fiscal policies and requests for the lowering of interest rates,” says Lim.

The Korea Credit Guarantee Fund and the Korean Technology Credit Guarantee Fund will also offer a special guarantee programme that will insure up to KRW300 million at a cost of 1%, a decrease from 1.3%. The programme will provide guarantees of up to KRW100 billion.

To empower small businesses, the government will provide special loans worth KRW100 billion from its Small Business Fund, while local credit guarantee funds will provide special low-cost guarantees for up to KRW50 million per business at a cost of 0.5%. A total of KRW100 billion worth of guarantees will be offered by local credit guarantee funds.

“Private consumption is projected to weaken in the second quarter this year, and it is possible that a delayed recovery in consumption sentiment could magnify uncertainties, thereby imposing a drag on the recovery in corporate investment,” says Jung Kyu-Chul, associate fellow in the Department of Macroeconomic Policy at the Korea Development Institute (KDI).

Experts forecast Korea’s GDP to post a slight contraction in the second quarter. According to Jung, the decrease will be much larger in the third quarter, displaying a partial rebound from the contraction in the second quarter, but its impacts across the entire economy will be almost trivial in the medium and long term. “The fact that May’s consumption-related indicators posted weak but better gains than April’s suggests that negative impacts from the disaster are likely to decrease at a gradual pace,” Jung asserts.

Consumer sentiment index declined in May but quickly rebounded in June. Moreover, Korea experienced a spike in retail sales in May compared to April.

“The Sewol disaster has taken its toll on the Korean economy, which had been on the road to recovery,” says Kang. “However, I believe that its direct impact will be limited and mainly fall into the second quarter. Korea will be expected to bounce back starting from the third quarter, especially when the US will clearly recover from the temporary recession of the first quarter in full scale.”

Before the disaster, the president pushed forward deregulation measures to promote the service industry by boosting its productivity comparable to that of the manufacturing sector. Her agenda lost momentum when the ferry disaster exposed holes in the country’s safety regulations. However, with the appointment of a new finance minister and a major cabinet reshuffle, Park’s policy plans may simply need a little time to run their course.

Reducing household debt

Korea still faces headwinds from record household debt, which climbed to KRW1,021.3 trillion at the end of December last year, reaching 164% of household disposable income, well above the OECD average of 133%. In the fourth quarter last year, banks’ household lending widened to KRW8.4 trillion from KRW2.1 trillion in the third quarter, following more active housing transactions induced by the August 2013 measures to stabilize the leasehold and monthly rental markets.

The government set the goal of reducing the ratio of household debt to disposable income by 5% by 2017. In a separate plan also announced in February this year, the key measures to keep household debt in check are extending the maturity structure, encouraging a switch from floating-rate loans to fixed-rate to prevent future interest rate rises and reducing the debt burden of low-income families by restructuring high-interest debts to lower rates.
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A new debt relief programme aims to bring low-credit, low-income households back into the banking fold. The state-run National Happiness Fund (NHF) set up in March 2013, is worth up to KRW18 trillion, and has helped 249,000 waive half of their debt load in the year since it was set up. It buys loans worth less than KRW100 million that are more than six months in arrears from financial institutions and writes off up to 70% of the principal.

South Korea’s household savings rate has plunged from 19% in 1988 to 4% in 2012, among the lowest in the OECD. Loan repayments gobble up a quarter of a middle-class families’ income. According to the McKinsey Global Institute, over half the country’s households could be considered in deficit, paying out more in expenses than they bring in, up from 15% in 1990.

The government has set in place a number of comprehensive measures to facilitate structural improvement of household debt. “The government will set households’ debt-to-income ratio as a key performance indicator and work on the downward stabilization of the ratio by bringing it down by 5% by the end of 2017,” notes Kim Youngil, fellow with the Department of Financial Policy at the KDI. “The ceiling of tax deduction will be increased from KRW15 million to KRW18 million for borrowers of house purchase loans with fixed interest rates and redemption by instalment contracts, and borrowers of mortgage loans with 10-15 year maturity will be given a tax deduction, to be adopted in tax revision in 2015,” says Kim.

The government will launch a pilot programme, setting aside approximately KRW100 billion in 2014 to spur the transition towards long-term mortgages without a grace period (redemption by instalment contracts) from mortgages (short-term, balloon payment) provided by the non-banking sector.

Boosting employment

Korea’s employment rate has levelled off at close to the OECD average. To achieve the government’s 70% target, the agenda calls for the development of a creative economy that facilitates start-ups, thereby boosting employment.

By industry, employment improved in manufacturing, compared to the previous month, and services added over 500,000 jobs. By employment status, the number of regular workers continued to increase, but non-wage workers decreased.

The number of workers on the payroll in March had increased by 649,000 from a year earlier to 25,160,000 and the employment rate rose one percentage point to 59.4%.

The number of employed persons increased by 421,000 year-on-year during the third quarter of 2013, and went on to increase 541,000 by the fourth quarter. In January and February of 2014, the number grew to 770,000.

Of particular note is that employment in the services sector rose by 431,000, led by the health and social work sector, which was boosted by government policies such as the expansion of free child-care provision and by heightened demand for services associated with the ageing population.

The government’s key priority is to break down dualism in the labour market, which is severely segmented between regular and non-regular workers. Non-regular workers accounted for one-third of employment in 2012.

Labour market dualism has a number of negative implications for non-regular workers, namely the highest rate of worker turnover in the OECD, less access to training and employee benefits. The government has since tried to contain the use of non-regular workers by limiting their employment to two years.
The Shinhan Financial Group (SFG) corporate and investment banking division has been playing a pivotal role by focusing on risk management and building a variety of solution-selling capabilities. How do you foresee SFG overcoming limitations to existing asset management operations and coping with intensifying competition?

The transformed economic environment in the corporate banking field is typified by the now deeply rooted low growth, low interest rate structure. The ever-fiercer competition within the industry calls for a fresh template.

To tackle this changed environment and provide thoroughly differentiated corporate financial services, we launched in January 2012 a radically new type of corporate and investment banking business framework, in which banking and securities services play a decisive role, providing what we term a ‘One-Stop Total Solution’ integrating direct and non-direct financing.

Leveraging from this, we are strategically promoting the ‘creative operation of assets’, embodying the ‘creative finance’ that is the hallmark of the Shinhan Financial Group. This creative operation of assets presents an innovative approach that seeks to increase yields on the assets of our customers and not just those held by the bank itself. It embraces a total solution involving stepping up the operation of alternative investments in promising market areas in which we are competitive, putting in place integrated investment financing and the more active proposal of total solutions designed to meet customers’ needs.

We are now witnessing the first results of this consistent promotion of the creative operation of assets. We are building the main platform for this alternative investment and integrated investor financing, while setting up a broad range of funds led by SFG, examples of which include the Senior Loan Fund and the Japanese Solar Fund. The Senior Loan Fund is a matching fund that co-invests in acquisition financing led by Shinhan.
Interview: Jin-won Suh

Shinhan Bank’s 69 overseas offices recorded $39 million in operating profits June 1 quarter alone this year, a 40% increase from the same period last year despite global financial fluctuations. How do intend you to sustain such growth?

Briefly, the key figures for the performance of our overseas business sector in the first half of 2014 were quite strong, with total assets of $17 billion, on which we achieved total earnings of $86.2 million. Of this, operating earnings amounted to $63 million, a return on assets (ROA) of 0.78% with a 0.47% ratio of sub-normal credits. There were increases in total earnings and earnings for the period of 38% and 32% respectively.

The ROA, a key indicator of profitability, rose by 0.09 of a percentage point over last year-end and, over this same period, the ratio of sub-normal credits improved by 0.11 percentage point over last year-end.

Shinhan Bank has firmly established its position as the leading CIB market.

According to a Moody’s Global Investors Service report earlier this year, Korea’s banking system is stable but bank profitability remains low. What measures is Shinhan taking to overcome such economic hurdles?

Shinhan Bank has strongly pursued heightened global competitiveness through the continuous upgrade of the processes involved in credit screening and discretionary authority in decision-making, the improvement of localization schemes for human resources, and management of risk on a global basis.

Our intention is that this should go hand in hand with the identification of new sources of earnings through a twin strategy grouping a broad spectrum of channels including the expansion of strategic alliances and the acquisition of overseas financial institutions, along with the selective expansion of our network in promising markets.

The weight of SHB’s global business in our overall results has risen in line with the spectacular growth in five key markets we identified, including Vietnam and China, from around 3% at year-end 2010 to 6.5% for 2013 and further to 7.5% for the first half of this year. Our global business promises soon to become a key area of Shinhan Bank, thereby improving the domestic market-dependent profit structure.

The narrowing of our reliance on Korean-related business and the strengthening of localization in those markets where we have a presence are tasks that face us in further emphasizing Shinhan’s distinctiveness.

Toward this end, we are enhancing the various institutional frameworks and competences, including upgrading processes related to the localization of our systems in specific countries and the nurturing of the business expertise of locally hired staff. We also intend to augment activities designed to attract outstanding customers through the recruitment of high-calibre local marketing staff.

It is our intention constantly to launch differentiated strategic products that accord with the characteristics of our various local markets, such as the instalment savings and civil service loans of Shinhan Vietnam, the housing loans of our Indian network and the postal application of currency exchange service of SBJ.

We are stepping up our monitoring of promising regions with a view to advancing into them to secure sources of medium and long-term growth and a leading (commanding) presence (market leadership).

I think that we can anticipate building up our network concentrated on key markets by way of a broad range of methods, including not just greenfield-type new establishments, but also M&A and taking capital stakes in existing entities. In this way, we are looking to raise the weight of global business in our overall business earnings to 8% in the near term, and to more than 10% over the medium and long term.

“We are striving to increase the proportion of our earnings from fees and commissions by a focus on non-interest business income, such as from investment products, foreign exchange, derivatives and investment banking”

Jin-won Suh
we do things and seeking to achieve efficiency in strategic costs. In addition, in the situation in which the pattern of financial transactions is undergoing a sea change, we are about to set up what we call a ‘Channel Transformation TF’ which will work for the improvement of our operating methods by thrashing out new channel operational models and improving organizational/results management frameworks and the way things are done. Although a relative newcomer, Shinhan has been able to grow into today’s benchmark bank for Korea by virtue of the ceaseless innovation and indomitable spirit of challenge that characterize it. With creative challenges such as we have not faced in the past, we will continually improve our profitability and sustain our diversifying growth.

Shinhan Financial Group has managed credit risks through a stable growth strategy and stabilizing allowances for bad debts. Yet South Korea’s lingering household debt crisis continued to affect private consumption. What measures you have in place to restabilize Korea’s economy?

Korea’s household debt has swollen to such an extent that it is shrinking consumption and hampering economic growth. If this situation is allowed to continue, with the depression of domestic demand worsening further, we could, it is feared, repeat the Japanese experience of 20 lost years, suffering prolonged low growth coupled with near-zero inflation and falling asset prices.

Shinhan Bank has been able to manage credit risk through its forward-looking risk management and stable asset growth. As of the end of June the default rate stood at 0.46%, which was a 10 basis point improvement over the same period last year. The ratio of non-performing loans similarly registered 1.12%, a year-on-year improvement of 31bp. These were the most favourable levels among domestic banks and they clearly testify to Shinhan’s competitive advantage in terms of its capacity for effective management of its soundness.

For its part, the government is putting in place a package of measures to address the household debt problem. It is encouraging the conversion of variable rate mortgage loans that are vulnerable to interest rate changes to fixed rate loans and of bullet-type redemption loans, which pose a heavy burden at term, to loans with amortized redemption.

Our role as a ‘partner in success’ of domestic firms is also considerable. To facilitate the friction-free overseas advance of domestic firms, Shinhan Bank operates a global support desk making active use of the bank’s global network. It also runs a ‘corporate success programme’ to assist both financially and non-financially firms experiencing short-term cash flow problems, as well as an SME healing programme. Not only do these schemes contribute to firms’ success and national economic development by the avoidance of corporate insolvencies, but they also assist in the stabilization of the bank’s allowances for bad debts.

Shinhan Bank stands ready to assist in keeping with the government’s policy directions for the stabilization of the Korean economy as the bank pursues the strategy drawn up at the beginning of this year. The bank is exploring proposals for

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net income. As of the end of 2013 ROA came in at 0.60%, considerably higher than the average 0.38% for the banking sector as a whole.

Yet we still have shortcomings when compared to advanced banks globally. More than 80% of our earnings are achieved through the spread between deposit and lending rates and regionally we are preponderantly domestically focused. Indeed, given the current structure of our earnings, if this low growth/low interest rate environment becomes entrenched, there is a strong possibility that our profitability will be further eroded.

Shinhan Bank is undertaking a number of initiatives to cope smoothly with this state of affairs. While doing our best to manage net interest margin by securing appropriate deposit loan spreads, and increasing core liquid deposits, we are striving to increase the proportion of our earnings from fees and commissions by a focus on non-interest business income, such as from investment products, foreign exchange, derivatives and investment banking. In tandem with this we are concentrating the bank’s capabilities by selecting core businesses so as to tie in competitiveness that sets us apart in future growth markets. We have the products and infrastructure in place giving us a lead in the retirement planning business and we are enhancing customer management and product sales through non-direct channels.

In regard to global business, on the basis of our medium and long-term strategy of ‘building an Asian financial belt’, we have constructed the largest network of any Korean bank, with 69 offices in 16 countries. Over the past two years we have achieved substantial endogenous growth, with all channels realizing a surplus. Looking ahead, we are planning to emphasize still more strongly our global localization by the active recruitment of talent from the countries concerned while expanding our local customer base.

While it is essential to strengthen our business capacity and to advance into new markets to raise profitability, this must be fully backed up by a drive to heighten efficiency and productivity in our operations.

We are continuing to improve the management of our human resources, including optimizing the organizational structure for each division and field-centred personnel management policy. We are also striving for innovation and improvement in the way
contributing to the revitalization of the real economy.

In particular, as the government’s new economic team has recently drawn up new guidelines for economic policy, we at Shinhan Bank are now closely studying the various aspects involved with the firm intention of providing active support in those areas in which this is feasible to get the real economy moving forward again.

**In May, Shinhan launched a wealth management (WM) solution team, a group of specialists providing integrated tailor-made asset management services for the bank’s private wealth management clients. What long-term objectives do you envisage for this move?**

Shinhan Bank has for some time been successfully running its ‘customized consulting service team’, made up of leading experts from within the bank, which targets very high-net-worth individuals. On the basis of this experience, we launched the ‘WM Solution Team’ this May to provide diverse tailor-made asset management services to a broader range of clients.

WM Solution Team makes use of a core platform to offer integrated asset management solutions. It is made up of three experts in finance, tax matters and real estate and comes under our investment products and services (IPS) division. It is able to provide further consulting by working with experts on bonds, equities and research by making use of Shinhan Financial Group’s PWM joint framework that links banking and securities.

I think that we will see several beneficial effects from this initiative over the long term. Firstly, Shinhan Bank has now built up a flawless operational support framework for individual customers with the establishment of this WM Solution Team.

We anticipate that, with the establishment of this team targeting those with assets of at least KRW1 billion, we will be able to offer a broad raft of diverse asset management services tailored to clients’ circumstances and needs along with the existing ‘Together with the Experts Service’ for those with assets of more than KRW300 million and the ‘Tailored Solutions Team’ for those with assets of more than KRW5 billion.

Secondly, since the launch of the WM group it has become possible to maximize the synergies for comprehensive support. It should contribute greatly to customer retention and attracting new customers, as it will enable the integrated provision through a single team of tax advice, real estate and asset management services that were previously offered on an individual basis.

Thirdly, we now have great competitive strength in wealth management that is keenly appreciated by high-net-worth individuals. By offering expertise and convenience in putting into practice our philosophy of customer-oriented asset management, the ‘Shinhan’ brand will be gaining great competitiveness as the first name among financial groups in the retention and attraction of high-net-worth individuals.

The wealth management business bids fair to become a core business area, leading a new advance in the retail sector, which has been showing only subdued growth.

Shinhan’s ‘PWM Business model’ and ‘Integrated Asset Management (Operational) Support Framework’ are expected to play a major role in Shinhan Bank’s diversification of its growth momentum.

**You announced plans earlier to mobilize the bank’s workforce to boost ‘financial hallyu’ abroad. Can you elaborate?**

Shinhan Bank’s selection and focus and the construction of an Asian financial belt represent the paths by which we intend to pursue greenfield advances and organic growth by concentrating on those growth markets where we can secure competitive advantage.

Notably, we select those regions in which we wish to establish a new presence through meticulous market analysis with a heavy weighting given to those areas that have growth potential and cultural empathy with Korea; consequently, we have given very positive consideration to Southeast Asian countries. In promising emerging markets, Shinhan Bank is at the forefront in spreading ‘financial hallyu’ through face-to-face and indirect channels.

Shinhan Bank is pursuing a wide range of methods to cultivate and nurture staff in those countries where it has a presence so as to heighten the competence of key employees among its locally appointed staff. Outstanding employees selected by the general managers of overseas branches are invited to Korea to attend the ‘Global Academy’. The purpose of this is to pass on to them Shinhan Bank’s know-how and best practice in key operational areas; upon return to their branches they are able to disseminate this among their fellow employees.

Moreover, we run a ‘Global Leader Group’ to gather overseas opinions. After excellent local members of staff have been chosen, they are invited to Korea so that they can experience at first hand and come to a deep understanding of the parent bank’s history, culture and strategies. In this way, the growth of a core of key global Shinhan staff, who take pride in being ‘Shinhan men’ or ‘Shinhan women’, is further encouraged.

So as to put Shinhan’s mission of ‘compassionate finance’ into action more effectively, the entire global network, including the parent bank, observe a ‘Shinhan Mission Day of Warmth’ every month. The objective of this and other creative initiatives is to incorporate compassionate finance within the organizational culture and put it into practice consistently in the daily routine so as to emphasize customer and social values.

Furthermore, in tune with the demands of the times and in keeping with our social responsibilities, we are continually engaging in a broad range of activities that contribute to society wherever we have a presence. Representative examples of this are our tuition scholarship support project in Vietnam, medical support project in Uzbekistan, the establishment of an educational centre in Indonesia to help members of disadvantaged groups form a base so they can stand on their own feet, and support for improvement of the educational environment in Myanmar. Moreover, by expanding conventional educational opportunities with the socially disadvantaged, while forming linkages of friendship and mutual development, Shinhan Bank is gaining recognition as a model corporate citizen in its host countries.
Shinhan strives for greater growth

Already South Korea’s leading financial institution, Shinhan Bank is aiming to continue growing by enhancing its private wealth management offerings to high-net-worth customers.

SHINHAN BANK (SHB) remains South Korea’s leading financial institution. Its domestic network posted a net profit of KRW841 billion as of June, up more than 20.5% from the same period last year, the highest revenue among the nation’s financial institutions. Moreover, its 69 overseas offices recorded $63 million in operating profit during the first half of this year, a 32% increase from the same period last year, a significant earnings growth record for SHB. The figures represent a remarkable performance in all sectors, including growth, profitability and asset quality.

Despite a lengthy downturn at home, SHB was able to maintain its position as one of South Korea’s best banks, boasting the industry’s highest return on assets (ROA) and return on equity (ROE) profitability indicators. Shinhan Financial Group ranked first among South Korea’s financial institutions by placing 30th on the Global 100 Most Sustainable Corporations list at the Davos World Economic Forum. Shinhan also ranked first in Korea and 43rd in the world in the Top 500 Banking Brands list compiled by The Banker magazine.
Shinhan Bank

As Korea’s leading financial institution, SHB has achieved impressive sales performance in all areas of the market. Moreover, SHB supported government programmes with loans of up to KRW640 billion in the first half of 2014, by lowering interest rates, converting borrowers to instalment loans and deferring interest through the SHB household debt healing programme.

In 2013, the total value of SHB’s retirement pension assets under management (AUM) reached KRW8,818.6 billion, making it South Korea’s industry leader for the fourth consecutive year. SHB also ranked first for the third consecutive year in terms of reserves for management operations, with KRW8,170.7 billion. SHB’s high rate of quantitative growth is reflected in its rapidly increasing customer base.

“We did this by focusing on low-cost deposits and loans to small and medium-sized enterprises,” says Shinhan CEO Jin-won Suh. “We also continued with our globalization strategy, building the largest overseas network of any South Korean financial institution.”

SHB’s strategic goal for 2014 is ‘Creative Challenges, Differentiated Growth’. This includes responding carefully to any and all changes in the global financial marketplace.

“While the Korean financial industry is facing a significant turning point due to prolonged low growth and a rapidly ageing population,” says Suh. “Our goal is to retain our competitive edge in our key markets by pre-emptively responding to changes in the constantly shifting paradigms of the times.”

Private wealth management

SHB established the Wealth Management Business Unit to raise customer value and secure future growth engines by following a new, group-wide, synergistic model built on cooperation between the wealth management departments of Shinhan Bank and Shinhan Investment Corporation.

Shinhan Private Wealth Management (PWM) is now in its third year of operation. Opened in 2012, its growing network of PWM centres offer a host of customer-oriented diversified wealth-management services, forging a cross-channel infrastructure that showcases investment products and services from both bank and brokerage units.

To further cement SHB’s vision of ‘building a better future as one of the country’s most respected and favoured premier financial institutions’, the bank established the Investment Products & Services (IPS) unit, the first of its kind in Korea, which focuses on delivering comprehensive wealth management products and services support from both bank and brokerage businesses. The move will help SHB provide timely investment insight and optimal financial solutions so that its customers can effectively respond to various market issues.

Its IPS division offers comprehensive investment solutions and a series of asset management products and services that are tailored to customers’ needs by integrating group-wide products, investment, real estate and tax expert advisers all under one roof.

Shinhan’s PWM has achieved remarkable growth since its inception. Despite unfavourable economic conditions that triggered low rates, Shinhan PWM has reaped the gratifying result of a KRW3.4 trillion increase in new assets under management. Moreover, in the two years since the PWM launch, Shinhan has attracted the highest rate of high-net-worth customers with financial assets exceeding KRW1 billion. Shinhan converted six of its private banking centres into PWM centres this year to shoulder rising demand and built a total of 25 national asset management networks.

In May this year, SHB launched its WM Solutions Teams to offer more systematic and comprehensive services to attract clients and provide them with a one-on-one integrated asset management service. Teams are made up industry experts on finance, tax and real estate from the IPS division and offer individually tailored asset management services for Shinhan’s PWM clients to maximize financial returns.

“We plan to further widen the lead over our competitors in terms of products and services,” says Suh. “We are intending to further upgrade the arrangements for the post-facto management of investment products and enhance the role of returns for our clients in order to strengthen our customer-value centred asset management.”

“Our goal is to retain our competitive edge in our key markets by pre-emptively responding to changes in the constantly shifting paradigms of the times”

Jin-won Suh
Outpacing its peers

South Korea’s rising score trend underpins its appeal as a relatively safe haven for emerging market investors. The sovereign has risen through Euromoney’s country risk global rankings more than any other in Asia so far this year, but its risk indicators depict a nuanced and constantly shifting kaleidoscope of political, economic and structural patterns.

The possibility of an outright sovereign default for South Korea or of any situation approaching repayment difficulty is very low, according to Euromoney’s Country Risk Survey, with the country improving this year after weakening slightly in 2013. ECR’s unique ‘crowd-sourcing’ approach to assessing sovereign creditworthiness ranks the nation a lofty 22nd out of 186 countries worldwide, rising eight places since the beginning of 2014. That striking performance, unrivalled among Asia’s emerging markets, is reflected in Korea’s low benchmark 10-year bond yield hovering just above 3% as of end-August. Korea’s five-year CDS spread, measuring the cost of insuring sovereign debt against default, is currently 51 basis points. This compares to a 36 point spread for Japan, which is considered more risky by ECR’s experts, putting it in 26th place.

Korea’s total score of 70.4 out of a maximum 100 points (signifying the least possible risk) puts it in the second of ECR’s five tiered categories, containing fairly low risk investment grades commensurate with an A- to AA credit rating. Korea is currently ascribed stable ratings of AA- by Fitch, Aa3 from Moody’s and A+ by Standard & Poor’s. Among the various market opportunities in Asia, the sovereign ranks a little lower than Taiwan (in 18th position) and trails tier-one Singapore and Hong Kong, respectively third and 12th on the ECR scoreboard. Yet Korea is deemed a far safer bet than China, in 38th place, and is one of five emerging markets in a select group dubbed a ‘robust five’ based on their resilient score trends.

Swift recovery

South Korea’s risk profile was invariably disturbed by the aftershock of the 2008 global financial turmoil, but in contrast to the advanced and emerging market sovereigns weakened by the ensuing debt crisis stretching across and beyond Europe, the Asian tiger recovered swiftly. Its present risk score is remarkably similar to that prevailing in 2007. Plus, Korea for the most part avoided the escalating risks witnessed last year among countries with shakier fundamentals. Speculation concerning the tapering of the US Federal Reserve’s quantitative easing (bond purchase) programme saw substantive capital outflow from emerging markets burdened with twin fiscal and current account deficits. Korea has notably avoided those problems, benefiting as much as anything

Source: Euromoney Country Risk; IMF; credit ratings agencies

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<tr>
<th>TIER-TWO SOVEREIGNS</th>
<th>AUGUST 2014</th>
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<td>Country</td>
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Sources: Euromoney Country Risk; IMF; credit ratings agencies

“Korea is deemed a far safer bet than China, in 38th place, and is one of five emerging markets in a select group dubbed a ‘robust five’ based on their resilient score trends”
“The strong external position should ensure Korea remains one of the least susceptible EM nations when the US Fed raises interest rates”

else from its export-oriented hi-tech economic structure. Capitalizing on its low risk profile, Korea completed the sale of its first 30-year sovereign bond in June, raising $1 billion to bolster its already strong foreign exchange reserves position alongside €750 million in 10-year notes, the country’s first euro-denominated debt placement in eight years.

While there can be little room for complacency - a fact underscored by the government using fiscal stimulus recently to pump-prime the economy and ensure insipid GDP growth in the second quarter moves back up to a faster pace - there is little cause for alarm with such strong risk indicators. Four of Korea’s five economic risk sub-factors have been upgraded this year by the 17 economists and other Korean country risk experts taking part in the survey - among them several of the prominent institutes the country is noted for with its prolific supply of high-quality research output.

Banks improving
Bank stability, a key concern in the light of the credit bubble evinced in a high household debt burden approaching 140% of disposable income last year, has been upgraded to a comfortable, but not entirely risk-free, 6.2 points out of a possible 10. The latest financial system stability assessment from the IMF, published in May, takes a balanced view, noting that “while the vulnerability of the Korean financial system has diminished considerably since the 2008 crisis, risks remain”. Profitability is viewed as weak, regulatory shortcomings persist, and household and corporate exposures are a concern, especially among less regulated non-bank financial institutions. The report nevertheless points to improvements in bank ratios, including capitalization (exceeding 10% even under worst-case stress scenarios) as well as solid foreign-exchange liquidity and a low level of non-performing loans in response to an active policy disposing of bad assets.

The employment/unemployment indicator, similarly upgraded by risk experts this year, is the highest scoring of all on 7.3 out of 10, highlighting the tight labour market with an unemployment rate slipping to 3.4% (seasonally-adjusted) in July. Employment creation across the manufacturing and service sectors is easing concerns among the youngest job-seekers, where difficulties in finding work are more problematic, while relieving the fiscal burden on the state.

Meanwhile, with Korea’s gross national saving rate regularly topping 30% of GDP, exceeding its gross national investment by a comfortable margin, a strong current account surplus, moving above 5% of GDP in 2013, seems guaranteed to last. A tight rein on foreign borrowing has kept the external debt-to-GDP ratio close to 35% of GDP, with debt servicing costs on medium- and long-term liabilities less than 8% of the value of goods and services exports. Ample reserves twice covering Korea’s short-term debt liabilities at residual maturity and providing more than six months of import payments exceed the IMF’s recommended minimum.

John Sharma, an economist and one of ECR’s Korean experts at National Australia Bank, says: “The strong external position should ensure Korea remains one of the least susceptible EM nations when the US Fed raises interest rates.” The current account surplus amounted to $53.03 billion during the first seven months of 2014, a 21% improvement on the corresponding period of 2013, and “there continues to be strong demand for Korea’s exports, such as machinery and transport...
equipment, with Korea’s foreign exchange reserves swelling to $368.03 billion,” Sharma adds. In its most recent (April 2014) Financial Stability Review, the Bank of Korea, the central bank, indicated that external risks had lessened considerably.

But macroeconomics, while important, is only part of South Korea’s favourable risk story. The ECR survey contributors are asked regularly to assess 15 economic, political and structural indicators in total, which are then added to scores for access to capital, credit ratings and debt indicators to generate the total risk score, all weighted according to their importance in explaining debt default. No measure of investor risk is foolproof, but ECR score trends have proved to be reliable early warning indicators of changing creditworthiness over the years. They have often preceded the agencies’ rating actions, notably in a downwards direction when investors require prompt advance warning of problems emerging.

**Stable government**

Korea’s political risk, having weakened in 2013, has improved this year. Government stability, one of four sub-factors with upgraded scores, demonstrates how President Park’s ruling Saenuri-dang (New Frontier Party) has to some extent alleviated public concerns surrounding governing institutions and ministerial competence that was damaged by the Sewol ferry and hospital fire tragedies. The government performed better than expected in mid-term local elections this June. Investors are assured of a fairly trouble-free period for policymaking through to the national elections in 2016, followed by the presidential decider a year later, given the government’s parliamentary majority.

Tense relations with North Korea are always a background concern of course. However, investors and risk experts have learned to ignore the fluctuating threats and olive branches posed by the decades-long armistice. Pyongyang’s desperate need for foreign currency ensures that economic exchange gets priority over belligerence, as the resumption of operations at the joint Kaesong industrial complex illustrates.

Meanwhile, the risks of non-payment/non-repatriation (already one of the highest scoring of the political indicators), together with the regulatory and policy environment, and corruption, have all eased this year. The World Bank ranks South Korea seventh out of 189 countries for ‘doing business’ and among the very best operating environments worldwide for trading across borders and contract enforcement, if somewhat weaker in other areas, such as investor protection. Its 46th place ranking out of 177 countries and territories in Transparency International’s Corruption Perceptions Index is adequate, but could be improved - as the recent, surprising arrest of five members of parliament (including three from the ruling party) on graft charges attests.

Structural indicators are more of a mixed bag. Three of the four included in the survey have improved this year, but whereas Korea’s ‘hard’ and ‘soft’ infrastructure - healthcare, for example - rank highly, with scores exceeding seven out of 10, demographics and industrial relations are entirely different matters, each totting up little more than half the points available. As with other countries in Asia, the birth rate is low at just 1.9 children per female, below the 2.1 required to stabilize the population. The number of Korean citizens will shrink rapidly from 50 million over the coming decades, ultimately constraining its growth potential as the workforce declines unless a concerted change in mind-set develops regarding immigration and social attitudes toward the family structure.

Strike action is also depressingly commonplace, notably on car production lines, with Hyundai Motors and other manufacturers blighted by a history of labour strife, and an extensive walkout taking place last year in the railway sector.

“Investors are assured of a fairly trouble-free period for policymaking through to the national elections in 2016”
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- **The Banker 2013** Best Bank in Korea
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