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Smile and Sunshine: Assessing the Impact and Sustainability of Microfinance in South Korea

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I. INTRODUCTION

Over the past 50 years, South Korea's economic growth and significant development achievements have received international acclaim. According to World Bank statistics, the South Korean economy grew on average 7 percent annually from 1961 to 2005. From the devastation after the Korean War in the early 1950s to membership in the Organization for Economic Cooperation and Development (OECD) in the mid-1990s, Korea has witnessed enormous social and economic changes. However, in the late 1990s, the Asian financial crisis plunged the country into chaos. This 1997 foreign-currency crisis shook the Korean economy and society. Income polarization broadened and credit rationing by commercial banks increased, further exacerbating economic repercussions. Many low-income families and business owners could not get loans, as interest rates skyrocketed and financial institutions shied away from riskier lending. As a result, low-income families were forced to rely on private moneylenders, who demanded exorbitant interest rates. In the decade that followed, Korea implemented strict economic regulations in order to safeguard against future crises. Its social policy, however, has not advanced. Therefore, when the global financial crisis hit in 2008, Korea's economy quickly bounced back while the nation's poor were plunged further into poverty.

South Korea affords an interesting case study of the advancement of social welfare policy in a growing Asian economy. Successive governments prioritized progrowth, industrial development at the expense of social welfare, but this changed after the 1997 crisis. In 2000, the Kim Dae-jung administration adopted the concept of productive welfare, linking social welfare policy with economic development. According to James Midgely and Kwong-eung Tang's 2010 article, "Social Policy and Poverty in Asia: The Role of Social Security," Korea has continued to promote the productive welfare approach, bringing the idea of social investment to the fore.

One of Korea's most recent productive welfare initiatives came in December 2009, when the Korean government established the Smile Microcredit Bank

(SMB). The bank provides unsecured loans to low-income households through partnerships with private-sector companies. The result is the world's first government-led microcredit lending program, benefiting small business, traditional market businesses, start-up businesses, and nonprofit businesses. In June 2010, the Korean government launched a follow-up to the SMB, the Sunshine Loan Program, providing low-income families funding for living expenses to help them get back on their feet.

These programs have garnered both positive and negative feedback. Proponents argue that the government's microfinance efforts address an "incompleteness" problem in Korea's credit market (in which demand outstrips supply) and will eventually make lending more equitable. Critics, on the other hand, say that these initiatives distort market principles and have the potential to increase household debt and moral hazard. It is too soon to tell whether these programs will significantly reduce long-term interest rates, creating new openings in the credit market credit at every credit level and redistributing wealth. However, it is possible to assess the early successes and failures of these initiatives, to evaluate the Korean authorities' responses to administrative and economic challenges, to offer strategies for improving microfinance in Korea, and, finally, to make predictions of future success or failure.

In what follows, section 2 examines the economic impact of the 1997 Asian financial crisis and the 2008 global financial crisis on Korean society. It then investigates why microfinance is a necessary component of the government's social welfare initiatives. Section 3 outlines Korea's current microloan programs: the Smile Microcredit Bank and Sunshine Loan Program. Section 4 analyzes these programs' initial accomplishments and failures and asks whether Korean financial authorities have succeeded in correcting any inadequacies. Finally, section 5 offers potential solutions to several of Korea's microfinance challenges and attempts to predict whether these programs will effectively address the country's income inequality and credit rationing in the long run.

II. SOCIAL STRATIFICATION IN SOUTH KOREA

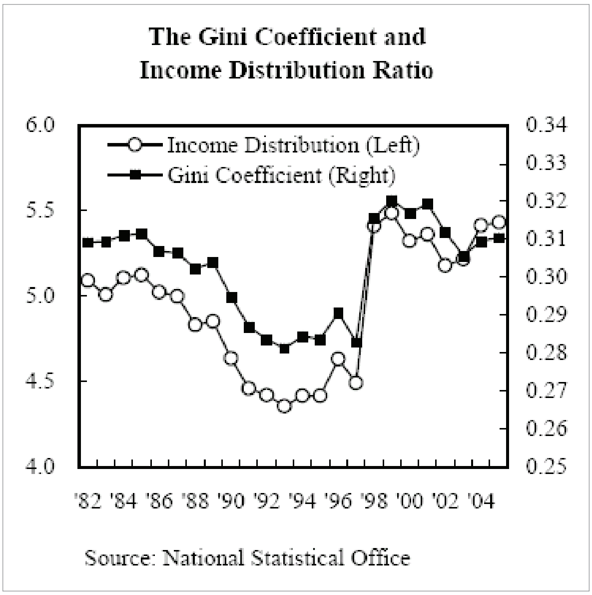
Since the 1960s, the South Korean economy has witnessed unprecedented growth. Economic development helped modernize industry, expand employment, eradicate absolute poverty, and elevate Korea to one of the world's largest economies. Nevertheless, the government had little success in building up the nation's social safety net. Throughout the 1970s, as argued by Youngsun Koh in his 2011 essay, "Changes in Income Disparity and Directions for Social Policy," the Korean government continuously introduced social security programs, such as health-care initiatives, pension programs, and unemployment insurance. These did little to mitigate poverty, but it was not until the 1990s, when financial liberalization swept the nation, that Korea witnessed a dramatic shift in income inequality and there was a rise in relative poverty, especially among the working-age population. These changes occurred with the growth of a knowledge-based economy and the accelerating pace of globalization, which put low-skilled workers at a disadvantage.

The Asian financial crisis struck in November 1997, further magnifying the holes in Korea's social safety net. According to Andrew Eungi Kim's 2004 essay, "The Social Perils of the Korean Financial Crisis," thousands of businesses went bankrupt overnight, unemployment doubled, banks were mired in more than $52 billion in bad debt, and in 1998 the annual per capita gross domestic product (GDP) plummeted from more than $10,000 to $6,000. Perhaps most strikingly, according to Kim, the 1997 crisis, "not only halted the nation's decades-long economic growth, but also brought about fundamental changes in lifestyle, employment patterns, corporate culture, and worldview."

Ill-equipped to handle the already existing social welfare problems, the system could not accommodate the massive influx of those in need, and significant economic stratification occurred. From 1997 to 1999, the annual earnings of the top 20 percent of urban households increased from 4.5 to 5.5 times more than earnings of the bottom 20 percent of urban households. According to the South Korean 2003 Household Survey, the top 10 percent of Koreans make 6 times more than the bottom 10 percent. Additionally, the number of Korean households living below the poverty line increased from 2.8 percent in 1997 to 7.3 percent in 1999. The size of Korea's middle class also decreased, and that of the upper and lower classes increased. In 2005, the percentage of Koreans in the lower and upper classes increased by 3.7 percent and 1.7 percent, respectively, in comparison to 1997 figures. In his 2010 dissertation, "Optimal Strategies for Developing Microfinance in Korea and the Impact of Microfinance," Korean economist Youngeun Yoon estimates that 1,747,000 members of the middle class shifted to the lower class as a result of the Asian financial crisis, while almost half that number (945,000) moved from the middle class to the upper class.

These figures are borne out by South Korea's National Statistical Office published in 2006 (see Figure 1). Prior to the Asian financial crisis, Korea's GINI coefficient, which measures income distribution (0 being most equal, 10 least equal), was relatively stable at 0.28. By 2000, however, this figured had climbed to nearly 0.32 and has hovered near this level for more than a decade.

Figure 1.



The 1997 financial crisis also led to a severe credit crunch in Korea. Banks and other financial institutions rationed credit, especially to those most in need. Credit rationing results from imperfect information in the credit market. Banks, as suppliers of funds, have inferior information about the expected yields of projects. If the yields increase, then the expected return to banks may decrease. The increased rates of return induce riskier borrowers to apply for loans, thus exacerbating the problem of adverse selection and the probability that borrowers may default on their loan. As rates rise, moral hazard also becomes a problem for banks; since a high rate of return boosts the relative attractiveness of riskier projects but carries with it a higher probability of bankruptcy. Changes in monetary conditions and structural changes in the financial sector led to a contraction in bank loans. This restructuring forced banks and other financial institutions to adopt risk-averse asset management and lending practices. As a result, interest rates increased, capital availability to lower-income brackets decreased, and banks insisted on collateral-based lending. These practices further drove down the supply of funds available to Korea's increasingly impoverished population.

The impact of credit rationing on Korean households led to a jump in the number of individual bankruptcies from 1,435 in 1997 to 2,207 in 1998. In addition, according to Sung Jin Kang and Yasuyuki Sawada's 2008 article, "Credit Crunch and Household Welfare: The Case of the Korean Financial Crisis," overall retail credit sales decreased by 32 percent from 1997 to 1998 and the overdue rate to credit card companies reached 20.3 percent in 1998. Not surprisingly, the financial crisis led to excess demand for loans. Because Korea's poor could not offer enough collateral to secure loans and needed cash for urgent purposes, they sank deeper into poverty. In the wake of this crisis, the Kim Dae-jung administration responded with government assistance and social welfare programs.

The Korean economy and collective psyche emerged from the 1997 Asian financial crisis battered and beaten. In the decade since, the Korean government has instituted reform measures designed to make the economy more resilient in future financial crises. The country's social security sector, on the other hand, has stumbled since President Kim implemented welfare reforms in 2000. Suffering from inadequate funding and governmental mismanagement, Korea's social welfare system has not yet found the most effective methods for correcting societal imbalances and providing support to its neediest citizens. Therefore, when the global financial crisis occurred in 2008, Korea's economy recovered with relative ease and efficiency, while strains on society were further aggravated. According to Chan Woo Jeong's 2011 policy paper, "Community Finance in Korea: Policy Directions," the 2008 crisis led to increases in income polarization, which, in turn, eroded the economic vitality of those in lower-income brackets and further exacerbated household imbalances.

With lowered credit ratings, income and job insecurity, and increased debt, Korea's poor again found themselves unable to secure loans from the nation's financial institutions. In accordance with new regulations and to protect themselves from default, banks, insurance companies, credit card companies, and even community-finance companies, reduced community-financing levels and turned to collateral-based lending. As a result, banks—hesitant to extend loans to suboptimal candidates, such as low-income households or cash-strapped small to medium enterprises—experienced excess demand for loans while the impoverished class, unable to get loans from traditional sources, turned to moneylenders and their excessive interest rates. Moneylenders in 2010 charged of 48.5 percent interest on average, more than six times the rate banks demanded of their high credit balance clients.

Restricted access to financial services has caused rapid growth in Korea's moneylending market in recent years. When major financial institutions—such as banks, credit card companies, capital companies, or savings banks—refuse loans to households with low credit, individuals obtain loans from moneylenders at prohibitively high interest rates. Along with these exorbitant interest rates comes the increased probability of bankruptcy or overwhelming household debt. Thus, Korea's economy has been weakened by the vicious circle its relatively poor borrowers are in: Low-income households are unable to improve their financial well-being because they cannot secure loans from large, reputable financial institutions; so they are pushed into high-interest loans that are difficult to repay and that, ultimately, degrade their credit rating. The more money they must dedicate to loan repayment, the further they sink into debt and the greater the likelihood of bankruptcy, which, in turn, erodes their already precarious financial situation. This "incompleteness," demonstrated by excess demand in the credit market, signals the need for government intervention to bolster Korea's loan and credit markets via state-sponsored programs and/or government incentives to private industry.

III. MICROFINANCE IN SOUTH KOREA: THE SMILE MICROCREDIT BANK AND SUNSHINE LOAN PROGRAM

Following the global financial crisis, countries all over the world took steps to help their most vulnerable and financially insecure citizens. In an effort to quiet South Korea's rattled economy and ease social tensions, the government established the Smile Microcredit Bank in 2009 and the Sunshine Loan Program in 2010. These programs provide low-income households with microcredit loans to support small businesses and prevent Korea's poor from falling further into poverty.

The Smile Microcredit Bank, an offshoot of the Miso Credit Foundation, developed out of the Thirty-First Emergency Economic Meeting in September 2009. President Lee Myung-bak had started discussions in January with the aim of "coming up with practical ways to overcome the global financial crisis," as reported by the South Korean broadcast network Arirang**.** The details of the SMB initiative were outlined in a July 2010 statement released by South Korea's Financial Services Commission (FSC). The SMB pledged, over the next ten years, to provide 2 trillion won ($1.72 billion) in the form of microcredit to low-income households. This funding exceeds the amount pledged over the previous decade more than thirteenfold. Although the Korean government launched the SMB initiative, the bank's funding and operation are managed by private organizations and NGOs. The SMB receives its financing through contributions from private-sector companies, such as Samsung Group, Hyundai-Kia, SK, LG, POSCO, and Lotte, as well as from other financial institutions. In a bid to draw more voluntary participation from the business sector, the government has offered tax incentives, designating a 50 percent tax reduction to those who donate to the Miso Credit Foundation. The SMB's operations are overseen by private bodies, such as nonprofit organizations and volunteer workers that are equipped with the necessary experience and skills.

According to the FSC statement, the SMB's target beneficiaries include small businesses, viable start-up franchises, non-franchise start-up businesses, start-up partnerships, and nonprofit organizations. Recipients will receive a loan between 5 and 100 million won ($4,300–$87,000), with a maturity date between one and five years. Interest rates will be set below the prime rate, which was anticipated at approximately 5 percent in 2010. The Miso Credit Foundation allocates funds to the financial institutions and organizations designated as branches of the SMB. These branches are independently operated. However, they do receive tax exemptions, since the SMB is treated as a charity organization under Korean tax law. Over the next decade, the FSC expects 200,000 to 250,000 low-income households to benefit from these loans. Moreover, the SMB initiative provides an avenue by which corporations can fulfill their social responsibilities while simultaneously allowing the government to reduce the financial blind spots in the Korean financial market. Finally, and perhaps most importantly, the FSC hopes the project will "arouse public sentiment towards charity and sharing their wealth, as well as expand[ing] the network of volunteer services."

The Korean government followed up the SMB in July 2010 with its Sunshine Loan Program. Unlike the SMB, which targets small businesses, the Sunshine's intended recipients are low-income households. The Sunshine Loan Program is the government's response to banks' credit rationing and low-income households' heightened demand for cash since the 2008 global financial crisis. Through this microloan program, the government hopes to reduce low-income households' reliance on private lenders and credit providers and, thus, to eliminate the burden of paying higher interest rates. Additionally, Sunshine loans are intended to insulate the poor from changes in the base interest rate—the lowest non-Treasury interest rate investors can get. For instance, under normal market conditions, those with low funds and poor credit bear the burden of an increased base interest rate through higher interest payments. Sunshine loans, however, limit recipients' interest payments by mandating an interest-rate ceiling.

The Sunshine Loan Program will disburse approximately 10 trillion won ($8.7 billion) over the next five years via private financial institutions. Sixteen regional credit guarantee foundations and the Korea Federation of Credit Guarantee Foundations (KOREG) will back these loans. KOREG will guarantee 85 percent of all loans, while the financial institutions themselves will be accountable for the remaining 15 percent; this is meant to prevent moral hazard and to encourage financial institutions to conduct a thorough assessment of each borrower's credit worthiness. The loans will be extended to individuals whose credit rating ranges from level 6 to 10 or to small-business owners whose annual income is less than 20 million won ($17,400). Delinquent households—those that have defaulted on previous loans or who cannot afford to repay their debt (and are thus undergoing a financial restructuring or are filing for personal bankruptcy)—will be ineligible. Financial institutions will set their own interest rates for Sunshine loans, but these rates will have a ceiling. The aim of the Sunshine Loan Program is to help low-income households start businesses, to provide operating capital for businesses, and to supply urgently needed living expenses. Ultimately, this program attempts to fill the "incompleteness" gap in the Korean loan market by giving low-income households access to financial services and decreasing their interest payments. If the average borrower receives a loan in the amount of 10 million won ($8,700) and, if the maximum 10 trillion won fund is distributed in loans over the next five years, then this program has the potential to benefit one million low-income households.

IV. SUCCESSES AND FAILURES

Since their implementation, the Smile Microcredit Bank and Sunshine Loan Program have sought to restore the credit of low-income households, or those in default, and to reduce the interest rates of moneylenders and credit-specialized financial companies. In theory, these policies should help alleviate market failures in the South Korean economy caused by financial companies' profit-maximizing practices. In the months following these programs' launch, both faced administrative, financial, and political challenges. At the same time, these programs have garnered a positive response from the Korean people and have achieved a measure of success. Initially, both SMB and Sunshine loans encountered organizational and administrative obstacles. In the case of the SMB loans, complaints ranged from the strictness of eligibility requirements to insufficient public awareness and inaccessibility of bank locations. The more significant problems involved the credit-verification process for bad-credit households and the absence of adequate financial and business training and support for borrowers.

For many of SMB's financial institutions, the easing of eligibility rules for low-income households was at odds with their credit verification systems. While commercial banks in Korea have a sophisticated mechanism for assessing individuals' credit rating, no such system exists for verifying low-income earners' ability to repay their debts. As a result, in the SMB program's early stages, banks were turning away many of the small businesses and low-income earners that the Smile loans were designed to help. To rate low-income earners properly, the government and the FSC will need to cooperate with private moneylenders—who will likely be reluctant to participate—to develop a system for assessing the characteristics of low-income individuals who, according to Yu Jung-suk, Samsung Economic Research Institute research fellow in his March 2010 *Korean Herald* article, "can repay their loans but will not take advantage of the system."

The second obstacle the SMB program encountered was the lack of a sustainable support mechanism. According to University of Cambridge professor Chang Ha-joon in a March 2010 Korean Herald article, granting microcredit loans without proper training or support for borrowers can be a "very powerful form of poverty trap." In response, SMB announced that it would overhaul its system to provide more effective support to its clients. To keep borrowers afloat, SMB plans to develop an evaluation system to monitor business performance. The results will then be used to set the amount and duration of the next loan. The bank will also outsource its employee education and training program to bolster staff expertise, and then these employees will disperse across the bank's 95 branches.

As a result of these obstacles, by June 2010 only 3,958 people had received loans, for a combined total of 23.6 billion won. By June 2011, thanks to improvements in SMB's credit-verification system and business-consulting practices, the FSC reported a total of 263.5 billion won ($230 million) lent to 28,728 borrowers. Of the SMB's beneficiaries, 62.5 percent had credit levels of 7 or 8 (at the very low end of Korea's 10-point credit-rating scale), which indicates that financial institutions are confident in the new credit-verification system. The SMB initiative has succeeded in widening low-income earners' chances of securing loans, and there is evidence of businesses being established. Yet, local community and SMB collaboration is still insufficient, and the business consulting and support needed to help clients succeed have not been successfully implemented.

The challenges encountered by the Sunshine Loan Program were the opposite of those initially faced by the SMB—Sunshine loans were popular and funds were disbursed rapidly. According to the FSC, on the first day of the Sunshine program 310 million won ($270,000) in loans were issued. By day nine, 10 billion won ($8.7 million) had been lent. In the program's first month, 61,663 borrowers received a total of 545.3 billion won ($463.3 million). This popularity challenged the Sunshine's viability and sustainability in two ways.

First, officials worried that the program might run out of funds. According to the FSC, 2 trillion won ($1.75 billion) had been set aside for loans from July 26, 2010, to July 25, 2011. But by early September 2010, approved loans had already surpassed 600 billion won ($523 million), putting the program on pace to distribute all funds by November or December 2010. However, loan demand slowed to a daily average of 3.6 billion won ($3.1 million) between October 2010 and June 2011, down from 21.2 billion won ($18.5 million) per day. As of the end of August 2010, most loans had been for basic livelihood assistance: 43,939 loans (71.3 percent), totaling 344.9 billion won (US$306 million). The second-largest portion of loans was for operating funds, at 28.7 percent and totaling 200.17 billion won ($175 million).

The reduction in daily loan amount resulted from the Korean government's addressing the second issue that challenged the Sunshine Loan Program—lax requirements. Unlike SMB loans, which impose strict requirements on borrowers, anyone with an annual income below 20 million won ($17.5 million) or a credit rating between 6 and 10 (i.e., low credit scores) is eligible for a Sunshine loan. Thus, high-income earners with poor credit were taking advantage of the system, and crowding out those most in need. In addition, Korea's financial authorities were concerned about the potential moral hazard related to KOREG's 85 percent guarantee of all Sunshine loans. Many worried that lenders would not sufficiently assess risk because the government would bail them out in case of default or financial stress.

As a result, the FSC tightened Sunshine's lending criteria in September 2010. Under the new regulations, people with a credit rating of 6 or below who earn more than 40 million won ($35,000) per year are ineligible. The FSC also stipulated that borrowers must seek Sunshine loans at banks in their own residential areas or an adjoining one. And to prevent financial firms from extending an excessive number of loans, officials increased on-site inspections. By June 2011, the Sunshine Loan Program had made 183,144 loans totaling 1.7 trillion won ($1.5 billion). In addition, the FSC reports that 58 percent of those benefiting from this program have credit levels of 6 and 7.

V. EFFECTIVE STRATEGIES FOR MICROFINANCE IN SOUTH KOREA

Overall, the public has responded favorably to both the Smile Microcredit Bank and Sunshine Loan Program. However, critics argue that these social welfare policies are still inadequate for effectively helping the disadvantaged. First of all, some experts believe that microfinance should be based on market principles. They contend that government intervention distorts the credit market and discourages private-sector institutions from entering the industry without incentives. Furthermore, because programs like SMB and Sunshine loans distort market principles, they provide an unfair advantage to individuals with poor credit, effectively rewarding bad credit and the negative behavior associated with it. In response, one policy suggestion has been to assign specific roles for Korea's financial institutions to create a "multilayer" system that addresses citizens' credit needs at every level. Initially, these roles would be assigned by the government and would occur in tandem with adjusted interest rates—not just for the low-credit individuals but for people at every credit level on the spectrum. This policy would regulate financial institutions' practices in the short run. Then over time, the rules would relax leaving in place a firm foundation for financial practices. A second critique of Korea's two microfinance initiatives is that a different agency within the government manages each program, leading to redundancy and conflicting approaches. To minimize these inefficiencies, an oversight board is needed to compile data, analyze program outcomes, and prescribe changes to both initiatives as needed.

Third, a problem of moral hazard for both lenders and borrowers exists. Low-rate financing backed by government guarantees encourages borrowers to apply for loans they may not be able to or intend to repay. At the same time, also because of government guarantees, lenders have incentive to extend loans to risky clients, knowing they will be bailed out if the loans are not repaid. Therefore, a mechanism is needed to minimize these moral hazard tendencies. For borrowers, there could be a more sophisticated system for evaluating low-credit individuals and their ability to repay their loans. Financial institutions and the government are in the process of creating this system, but it will take time before an effective assessment method is developed. Lenders could be made more responsible by increasing the percentage of loans that financial institutions guarantee. Doubling the current guarantee (from 15 to 30 percent) would significantly alter financial institutions' way of thinking and would thus minimize risky practices.

A fourth charge levied at the SMB and Sunshine loans is that they need to be accompanied by effective borrower education and training. At present, any such efforts are run by the regional branches of the lending financial institutions and tend to be ad hoc and loosely organized. A national-level training program that focuses on teaching loan recipients appropriate business skills would help remedy this. Each loan recipient could also be assigned a financial advisor at his or her local branch to monitor the borrower's progress and provide counsel. To do this, the government should create a department—perhaps an offshoot of the oversight board mentioned above—that focuses solely on borrower support and training. Without such measures, the worry is that these government loan policies are simply throwing money away, potentially doing more harm than good to Korea's overall economic development and especially to those on the lowest rung of the country's social ladder.

Finally, Korean finance authorities must enact measures that promote the sustainability of community finance, centered on microloans, based on market principles, and meet local demand for loans. Once SMB and Sunshine loans prove their profitability, community-finance companies will voluntarily expand their funding of such loans. In the meantime, however, if local financial institutions continue to shy away from providing funds for low-credit individuals, the government could mandate quotas for lending to customers with poor credit. Through these obligatory quotas, a multilayer structure in the credit market should emerge naturally.

V. CONCLUSION

South Korea's decades-long prioritization of economic expansion over social development led to significant fissures within Korean society. In recent years, to ease tensions and maintain social stability, the Korean government has made a point of pushing social reforms—many of which have failed. Korea's most recent attempt at correcting economic imbalances has been the Smile Microcredit Bank and Sunshine Loan Program, and these, too, have faced numerous obstacles to success. However, through careful analysis of borrower and program data, strict regulations, and collective oversight, Korea's microfinance programs have the potential to help reduce income inequality in Korea as well as to solve the problem of credit rationing for poor households.

At present, skyrocketing household debt and education costs are further exacerbating problems within Korea's economy and, consequently, its society. Therefore, programs such as the SMB and Sunshine are needed to rectify issues of income inequality and to help provide access to capital for those who need it most. Certainly, these initiatives have encountered some stumbling blocks in their early stages, but, for the most part, officials have responded swiftly and effectively. Critics of these programs, such as Democratic Party assemblyman Chung Dong-young argue that they have not effectively addressed Korea's social welfare problems. Alternatively, proponents, such as Grand National Party assemblyman Kwon Teag-ky, point out that these initiatives are getting funds into the hands of those who need them. Because these programs are so new, however, we cannot yet determine whether or not SMB and Sunshine loans provide a sustainable model for tackling Korea's social welfare problems.

Ultimately, social reform is necessary in Korea. However, it will not come about until Korea's policymakers find a way to work together. At present, as demonstrated by recent partisan conflict and protests surrounding the most recent updates to the US-Korea Free Trade Agreement, bitter divisions between Korea's political parties severely hamstring the reform process on practically every issue. Therefore, it is unlikely that progress will be made on any policy measures until these groups make a good-faith effort to stop wrangling with each other for power and, instead, find ways to work together to create a more equitable economic model and, thus, a more harmonious society.

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