Executive Summary

Unofficial translation

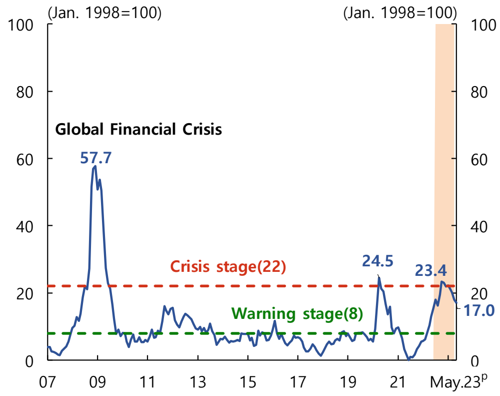
Please refer to the original report in Korean for the most accurate contents.

Financial Stability Situation and Risk Assessment

1. Financial Stability Situation

Despite global banking turmoil during the first half of this year, Korea's financial system has remained stable overall. The financial market maintained its stability with a decline in interest rates and an increase in stock prices. This was driven by expectations concerning the pace of adjustment in monetary tightening in major economies. The financial intermediation function of Korea's financial system operated smoothly, supported by sound loss absorbing capacity at financial institutions. However, the economic growth rate is slowing down due to factors such as a trade deficit, and financial soundness among households and corporations has deteriorated, especially in vulnerable sectors. The Financial Stress Index (FSI), which reflects the level of short-term instability in the financial system, temporarily rose to the crisis stage (23.4) in October last year due to the Legoland incident, but has declined since January this year.

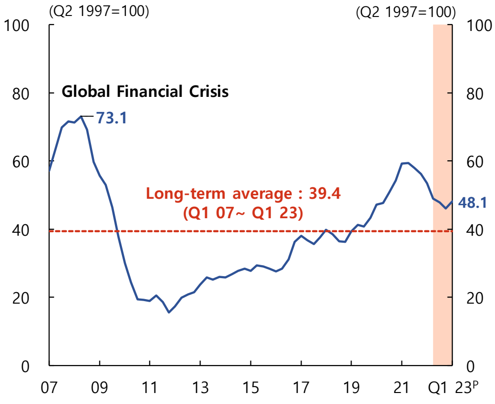
Financial Stress Index (FSI)



Source: Bank of Korea.

Potential vulnerabilities within the financial system have remained high. Untill the second half of last year, accumulated financial imbalances appeared to be shrinking as the growth of household debt slowed and as asset prices, such as stocks and real estate, declined due to the Base Rate hikes and a weakened risk preference among economic agents. This year, however, influenced by expectations of an easing of domestic and international monetary policy tightening, stock prices have risen, the decline in real estate prices has narrowed, and household loans have been increasing again since April, limiting the reduction of accumulated financial imbalances. The Financial Vulnerability Index (FVI), which shows overall vulnerabilities in the financial system from a medium- to long-term perspective, has slightly increased this year.

Financial Vulnerability Index (FVI)



Source: Bank of Korea.

2. Financial Stability Situation by Sector

IIn the credit market, the rate of private credit growth slowed modestly, particularly in household debt, and the private credit-to-nominal GDP ratio declined slightly, but remained high. Meanwhile, since April 2023, the sluggishness in the housing market and housing-related household loans have been on the rise again, so it is necessary to closely monitor the possibility that financial imbalances will expand again. In addition, the delinquency rate on household and corporate debt is rising, and if high interest rates and the economic slowdown continue in the future, it will be necessary to pay attention to the possibility that insolvencies could expand mainly among vulnerable borrowers, the self-employed, and marginal companies.

In asset markets, there had been heightened volatility in stock and bond prices caused by global banking uncertainties. However, they increased significantly as expectations regarding domestic and international monetary tightening changed. Credit spreads on corporate bonds significantly narrowed as credit risk aversion was alleviated with the government's market stabilization measures. Although the decline in housing prices has slowed this year, the level of housing price remains high compared to economic fundamentals. Price volatility could be amplified in response to changes in domestic and international financial and economic conditions, such as the pace of monetary tightening in major countries and real estate market policies.

With regard to financial institutions, asset growth slowed and asset quality deteriorated. Asset growth slowed at banks due to alleviated lending growth and also at non-bank financial institutions (NBFIs) owing to a decrease in investor deposits at securities firms and to the effect of the implementation of new accounting standards for insurance companies. Asset quality worsened across all financial sectors, affected largely by rising lending rates. Asset quality might deteriorate further as higher rates are gradually applied and as financial support measures for households and corporations are normalized.

As for capital flows, foreigners' domestic portfolio investment, both stocks and bonds, recorded a net inflow, but attention should be paid to the possibility of increased capital flow volatility depending on the occurrence of credit events at home and abroad, and the direction of monetary policy in major countries.

3. Resilience of Financial System

The financial system's resilience, which means its capacity to withstand domestic and external shocks, has remained stable, with capital adequacy ratios and liquidity ratios exceeding the regulatory standards. However, since resilience at some NBFIs, such as mutual credit cooperatives, has been deteriorating, they should make proactive efforts to build more provisions and increase capital in preparation for any future changes in internal or external conditions and shocks. Meanwhile, some NBFIs need to prepare for the possibility of sudden withdrawals of funds in line with increasing non-face-to-face digital transactions.

Korea's external payment capacity has remained solid overall. Net external assets have fallen, while the ratio of external debt to nominal GDP edged up higher, but official foreign reserves remained at a similar level as at the end of last year.

Meanwhile, payment and settlement systems operated smoothly under increased uncertainties at home and abroad. The amount of settlement on major payment and settlement systems, such as BOK-Wire+, has continued to increase, driven mainly by securities settlements by financial institutions and electronic funds transfers by individuals and companies. Settlement risks have also been managed stably.

4. Major Financial Stability Risk Assessment

As discussed above, the high level of household debt, housing price adjustments, and worsening corporate financial soundness, as well as weakened asset quality of financial institutions, still remain as the main vulnerabilities of Korea's financial system. Going forward, continued high interest rates, a real economic slowdown, such as sluggish exports, real estate prices resuming their decline, and possible instability in international financial markets could all have negative impacts on financial stability. This report thus mainly examines the effects of these domestic and overseas risk factors on the financial system.

First of all, overall financial stability risk related to the housing market seems to be managed at an appropriate level, considering that the actual volume of loan-related insolvencies due to the housing market slowdown in the second half of last year is not significant, and the resilience of financial institutions, except for some non-banking sectors, remains at favorable levels. However, public guarantees, which have greatly expanded due to the boom in the real estate market since COVID-19, are partially easing the impact of the adjustment of the housing market, but in the event of insolvency, the burden of subrogation of public guarantee agencies may increase.

If housing prices are adjusted in an orderly manner in the future, it will contribute to the gradual reduction of household debt by easing the burden of housing costs for households that rent and slowing demand for key money deposit loans in the medium- to long-term. However, if housing prices fall sharply again in a short period of time, the possibility of increasing the burden of returning key money deposits by landlords, an increase in the volume of unsold houses, and an expansion of insolvency in the real estate PF sector cannot be ruled out.

In addition, the results of an analysis of potential risks at non-bank deposit-taking institutions since the Silicon Valley Bank (SVB) bankruptcy shows that non-bank deposit-taking institutions, such as mutual savings banks and mutual credit cooperatives, are unlikely to experience the materialization of potential risks, such as liquidity shortages, given the ample capacity of their central federations to provide liquidity. Since these institutions are not closely interconnected with other financial sectors, the possibility for the potential failure of certain financial institutions to spill over into systemic risk are assessed to be limited. However, with the recent increase in NBFI deposit-taking through non-face-to-face channels, attention should be paid to the possibility of higher volatility of deposit outflows and inflows.

Meanwhile, although soundness indicators related to domestic bank corporate credit have remained favorable, it is highly likely that potential credit risks at corporations have not yet been fully realized due to financial support measures during the COVID-19 pandemic. The result of an examination of potential credit risks at corporations found that corporate credit risks had been underestimated due to the application of lower interest rates than their actual risks. Therefore, financial institutions need to prepare for increased downside risks in the real economy and the expiration of financial support measures in the future.

Policy Recommendations

To begin, if an economic slowdown continues amid the high level of interest rates, financial support measures for households and corporations suffering from momentary liquidity shortages need to be provided. Along with this, they should also refinance the debt of vulnerable borrowers and carry out necessary restructuring at the same time. However, policy authorities should encourage those household and corporate borrowers with debt repayment capacities to pay off their loans in order to reduce the pressure of debt accumulation.

While a slowdown in the real estate market could act as a factor in easing pressure on household debt accumulation, it could also lead to a deterioration in the soundness of financial institutions through an increase in non-performing loans. Therefore, it is necessary to clarify the targets and objectives of any policy to ensure a soft landing for the real estate market. As for real estate PF in particular, the authorities should provide support for businesses through micro measures or carry out prompt liquidation processes for each project site, while over the medium- to long-term horizon overhaul the PF-related regulatory framework to ease excessive risk taking by investors and to ease their pursuit of profit.

In order to respond actively to risks in line with changes in domestic and global conditions, financial institutions should be encouraged to enhance their loss absorbing capacity by building additional loan-loss provisions and through recapitalization. In particular, non-bank deposit-taking institutions, such as savings banks and mutual financial cooperatives, are likely to experience a deterioration in soundness as well as a higher risk of withdrawal. Therefore, it is necessary to strengthen supervision of these institutions to ensure that they maintain a stable deposit-taking structure and have sufficient liquidity.

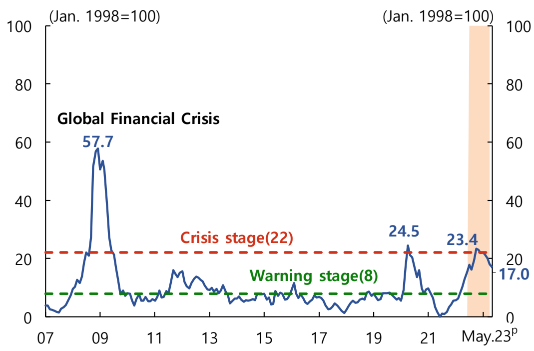
In addition, policy authorities will need to strengthen the early warning system and continue with their policy coordination efforts in light of heigthened uncertanties at home and abroad. Besides, while examining financial institution readiness for digital bank runs, more likely under the new financial environment that includes mobile banking, the authorities need preemptive management to prevent excessive market jitters by coming up with liquidity support measures for emergency situations in advance and taking swift action in case of emergency.

【 Key Indicators of Financial Stability 】

1 Overall Assessment

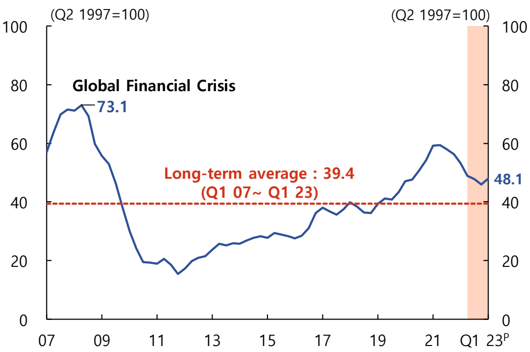
Decline in short-term financial stress (FSI)
Slight increase in mid- to long-term vulnerabilities (FVI)

Financial Stress Index (FSI)



Source: Bank of Korea.

Financial Vulnerability Index (FVI)

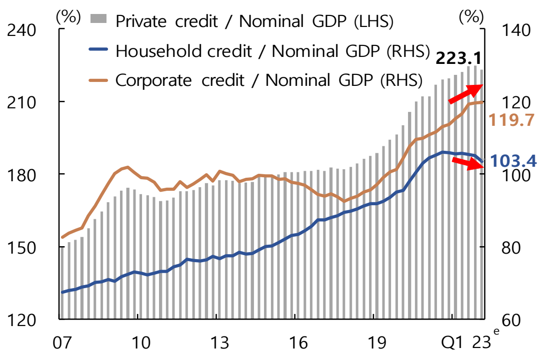


Source: Bank of Korea.

2 Credit Leverage

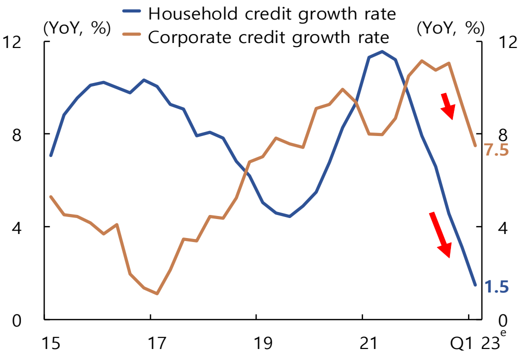
Private credit leverage remained high
Growth declined in household credit
Continued high growth in corporate credit

Private credit-to-nominal GDP ratios



Source: Bank of Korea.

Credit growth by sector

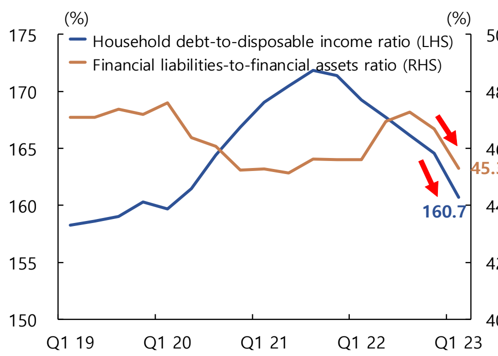


Source: Bank of Korea.

3 Household

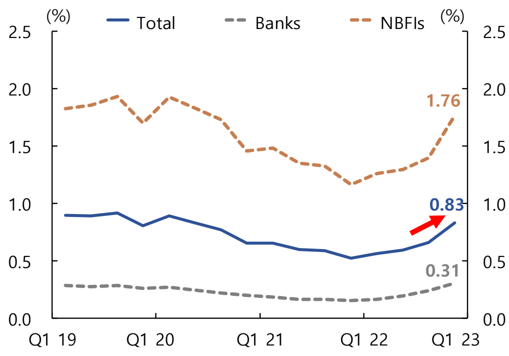
Solid household financial soundness
Increase in household loan delinquency rates

Debt repayment capacity



Source: Bank of Korea.

Household loan delinquency rates

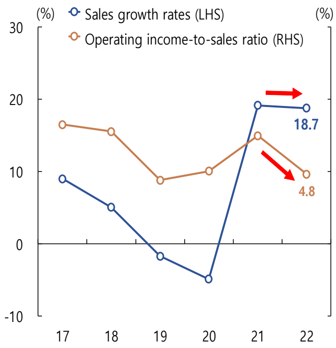


Sources: Financial institutions' business reports.

4 Corporate

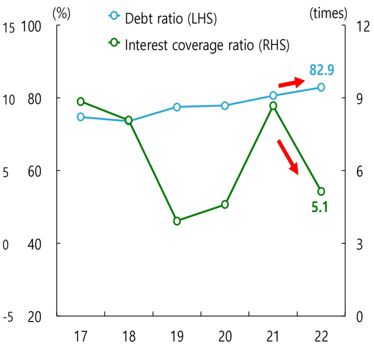
Decline in corporate profitability & interest payment ability
Increase in corporate loan delinquency rates

Growth potential & profitability



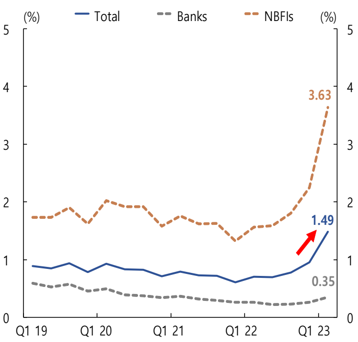
Source: KIS-Value.

Debt ratio & interest coverage ratio



Source: KIS-Value.

Delinquency rates of coporate loans

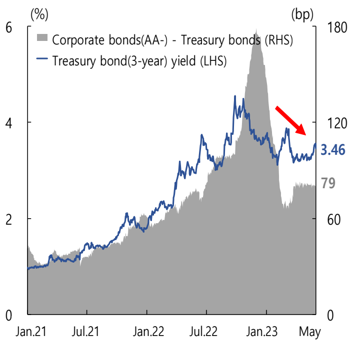


Sources: Financial institutions' business reports.

5 Asset Market

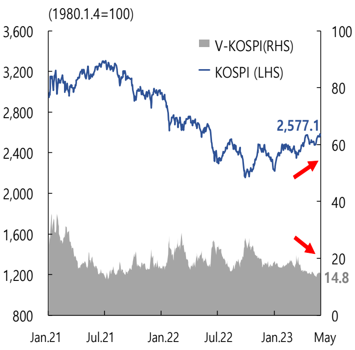
Decline in Korea Treasury bond (KTB) yields
Increase in stock prices
Slower decline in housing prices

Treasury bond yield & corporate bond credit spreads



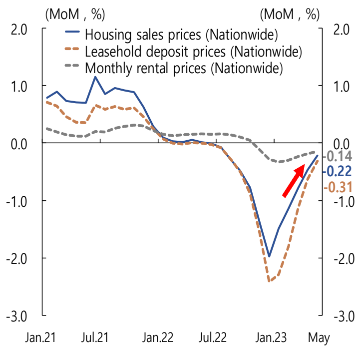
Source: Korea Financial Investment Association.

Stock prices & stock price volatility



Source: KOSCOM.

Rates of increase in housing prices

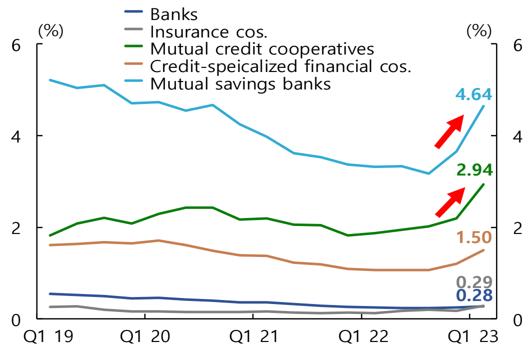


Source: Korea Real Estate Board.

6 Soundness of Financial Institutions

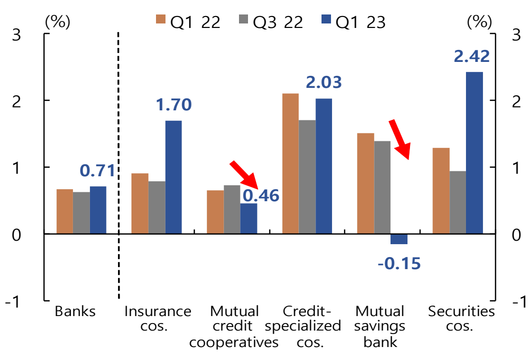
Decline in financial institution asset quality
Weaker profitability at some NBFIs

Substandard-or-below loan ratio



Sources: Financial institutions' business reports.

Return on assets (ROA)

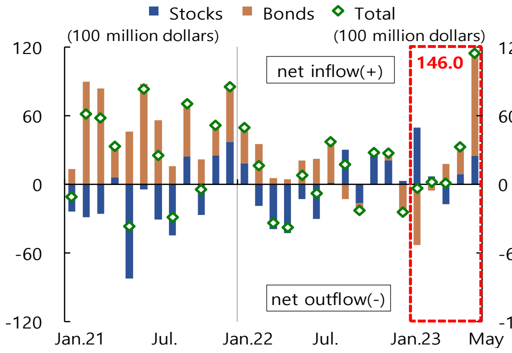


Sources: Financial institutions' business reports.

7 Capital Flows

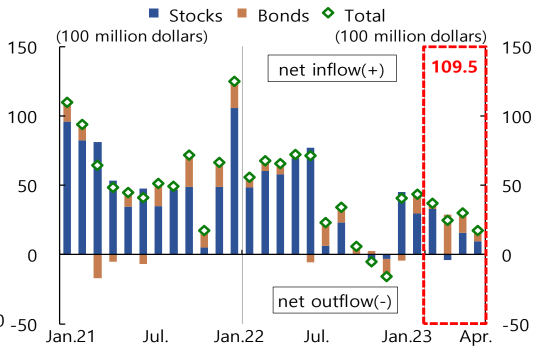
Net inflow of foreigners´ domestic portfolio investment
Slower growth in residents´ overseas portfolio investment

Changes in foreigners' domestic portfolio investment



Source: Bank of Korea.

Changes in residents' overseas portfolio investment

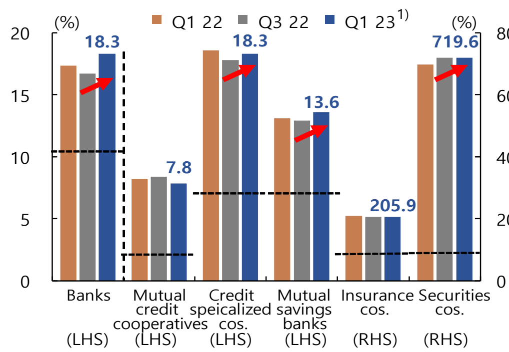


Source: Bank of Korea.

8 Resilience of Financial System

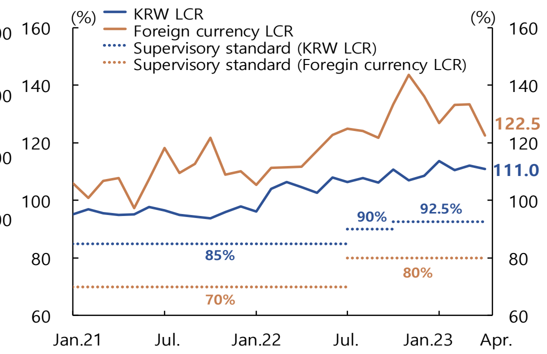
Strong resilience of banks & NBFIs

Financial institution capital adequacy ratios



Notes: 1) As of Q4 2022 for Insurance company.
Sources: Financial institutions' business reports.

Commercial banks liquidity coverage ratio (LCR)

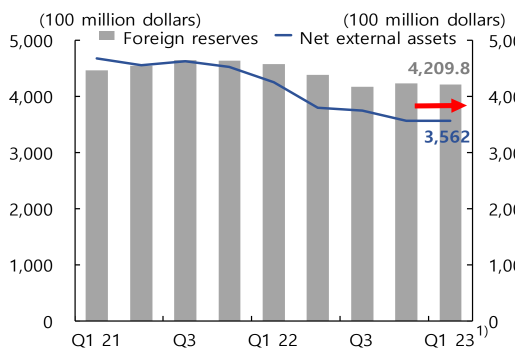


Sources: Financial institutions' business reports.

9 External Payment Capacity & Payment and Settlement Systems

Favorable external payment capacity
Stable settlement risk management

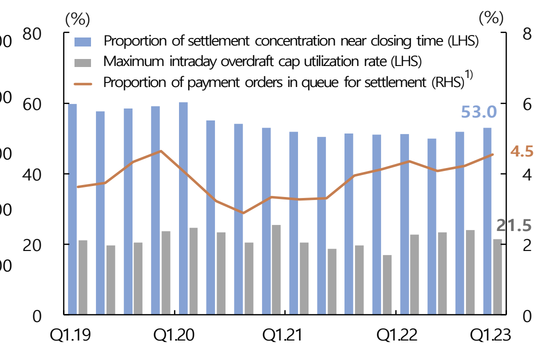
Official foreign reserves[1] & net external assets



Notes: 1) As of May 2023.

Source: Bank of Korea.

Risks related to BOK-Wire+



Notes: 1) Participating institution payment orders in queue for settlement / total settlement amount during the period (excluding payment orders for liquidity savings).
Source: Bank of Korea.