Executive Summary

Unofficial Translation

Please refer to the original report in Korean for more accurate content.

Financial Stability Situation Assessment

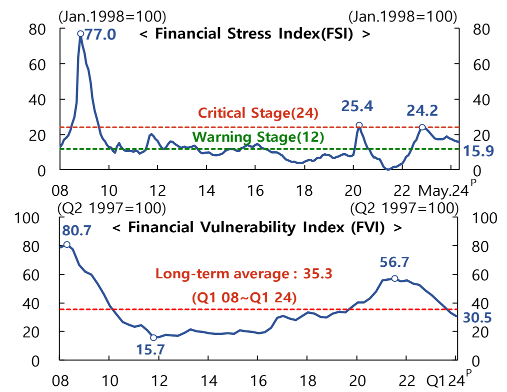
Korea's financial system has remained stable overall and the resilience of financial institutions, along with the external payment capacity, has maintained favorable conditions amid a real economic upturn. However, persistent debt repayment burdens on borrowers and concerns about deteriorating asset soundness in financial institutions due to sluggish real estate project financing (PF) remain potential destabilizing factors.

The Financial Stress Index (FSI)[1], which indicates the short-term instability of the financial system, modestly decreased to 15.9 in May 2024. However, the index remains at the warning stage, influenced by mainly rising delinquency rates at non-bank financial institutions among other factors.

Meanwhile, potential vulnerabilities within the financial system from a medium- to long-term perspective have continued to ease. Financial imbalances have been steadily decreasing, with the housing market remaining stable overall and private credit leverage declining. The external sector soundness also remains favorable despite uncertainty and exchange rate volatility stemming from global geopolitical risks.

In this context, the Financial Vulnerability Index (FVI)[2], which assesses medium- to long-term vulnerabilities in the financial system, declined substantially to 30.5 in the first quarter of 2024. This change marks a slightly drop below its long-term average of 35.3 since 2008.

Financial Stress Index (FSI)[1)3)], Financial Vulnerability Index (FVI)[2)3)]



Notes: 1) A comprehensive index (on a scale of 0-100) is derived by standardizing 20 monthly indicators from the financial and real sectors, representing short-term financial system instability. Thresholds for caution and danger levels are set at 12 and 24, respectively, based on the 'noise-to-signal ratio' method
2) A comprehensive index (0~100) derived by standardizing 39 indicators related to three assessment factors (asset prices, credit accumulation, and financial system resilience) representing medium to long-term financial vulnerability.
3) The index value may fluctuate in the future due to the parametric variability.

Source: Bank of Korea

Financial Stability Situation by Sector

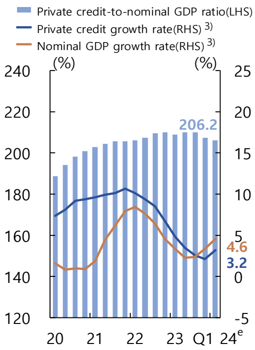
Regarding the credit market, private credit leverage has remained high but declined since the third quarter of 2023, reflecting a more favorable growth trajectory in the real economy compared to recent private credit expansion. Household credit growth rate remained low as contractions in unsecured loans and merchandise financing offset the growth in household debt driven by home mortgage lending. The overall household debt burden relative to income

1) The FSI is a comprehensive metric, ranging from 0 to 100, calculated by standardizing 20 monthly stress indicators from both the real economy and financial sectors. The thresholds for 'warning' and 'crisis' levels are set at 12 and 24, respectively, based on the noise-to-signal method. For further details, please refer to Box 7, 'Results of Financial Stress Index (FSI) Reform,' in the December 2023 Financial Stability Report.

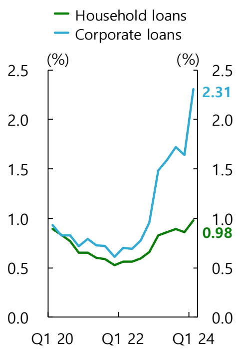
2) The FVI is a comprehensive metric, ranging from 0 to 100, derived by standardizing 39 indicators related to three assessment areas: asset prices, credit accumulation, and financial system resilience.

and assets decreased, but delinquency rates continued to rise, especially among vulnerable groups. Corporate loans saw steady but slower growth, primarily attributable to lending to SMEs. However, the debt servicing capacity in the corporate sector weakened due to sluggishness in major industrial sectors and increased interest burdens amidst ongoing delinquency rate increases.

Private Credit[1]-to-nominal GDP[2] ratio



Delinquency rates on household and corporate loans

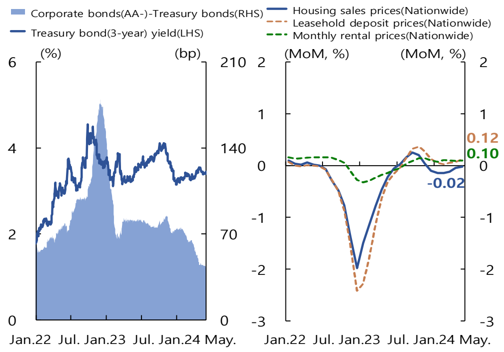


Notes: 1) Based on flow of funds statistics; estimated figure for Q1 2024.
2) Sum of nominal GDPs for the given and three preceding quarters.
3) Year-on-year basis.

Source: Bank of Korea, Financial Institutions' business reports

Asset markets remained stable overall with reduced volatility and narrower credit spreads while fluctuations in market interest rates and stock prices were influenced by shifting expectations around the monetary policy of major economies, geopolitical risks, and both domestic and overseas economic trends and inflation. In housing markets, sales prices continued to decline due to high lending rates and the tightened goverment policy on household debt management. However, there has been an upward trend in some areas, particularly in the Seoul metropolitan area. Leasehold deposits and monthly rents continued to rise, driven by growing demand for deposit-based leasing and monthly rents amid sluggish housing transaction activity. The volume of housing transactions remained below its long-term average, while the unsold new housing inventory saw modest growth. In commercial real estate, office rents maintained an upward trend, while shopping centers experienced sluggish demand.

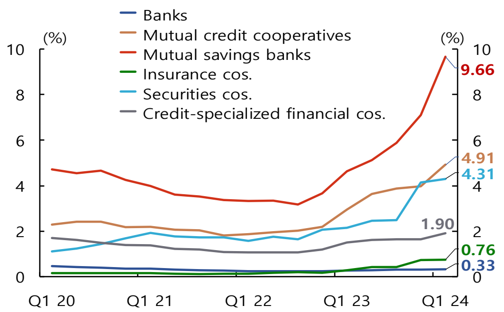
Korea Treasury bond (KTB) yields, corporate bond credit spreads, and rates of increase in housing prices



Source: Korea Financial Investment Association, Korea Real Estate Board

The soundness of financial institutions varied somewhat across financial sectors. Banks and insurance companies maintained asset growth trends and favorable profitability. In contrast, non-bank financial institutions, such as mutual credit cooperatives and mutual savings banks, experienced significantly slowed asset growth and deteriorating profitability as they tightened lending in response to rising non-performing loans. Securities and credit-specialized financial companies generally saw a decline in profitability despite asset growth. Meanwhile, asset soundness deteriorated across all financial sectors. While banks managed to keep their substandard-or-below loan ratios subdued through proactive non-performing loan management, the ratio increased significantly in the non-banking sector due to ongoing sluggishness in real estate PF.

Substandard-or-below loan ratio



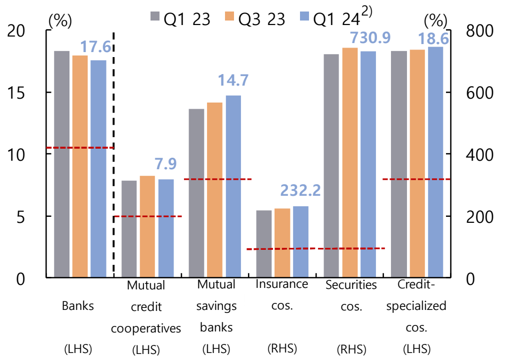
Source: Bank of Korea, financial Institutions' business reports

Regarding capital flows, both domestic stock and bond markets experienced net inflows of foreign investment, boosted by continued global demand for high-risk assets and expectations of improved domestic corporate performance. Residents also expanded their net overseas portfolio investments in both stock and bonds, driven by anticipated improvements in business conditions for IT firms and expectations of a U.S. Federal Reserve rate cut during the year. However, careful attention should be given to potential heightened volatility in capital flows, depending on changes in major countries' monetary policy and development in geopolitical risks.

Resilience of Financial System

The financial system's resilience, defined as its capacity to withstand domestic and external shocks, has remained stable. Although the provision coverage ratio is declining due to increasing substandard-or-below loans in most financial sectors, capital adequacy ratios and liquidity ratios significantly exceed regulatory standards across all sectors.

Capital adequacy ratios at financial Institutions[1)]



Notes: 1) The red dotted lines represent the regulatory levels for each sector
2) As of end-Q4 2023 for insurance companies
Source: Bank of Korea, financial Institutions' business reports

Korea's external payment capacity remained robust. Net external assets have reversed to an increase and external soundness indicators have improved, with the ratio of short-term external debt to foreign exchange reserves and the share of short-term external debt in total external debt declining as short-term external debt decreases.

Meanwhile, payment and settlement systems operated smoothly within the financial market infrastructure. The settlement amount on major payment and settlement systems, such as BOK-Wire+, continues to rise, driven mainly by securities settlements by financial institutions and electronic funds transfers by individuals and companies. Settlement risks have also been stably managed.

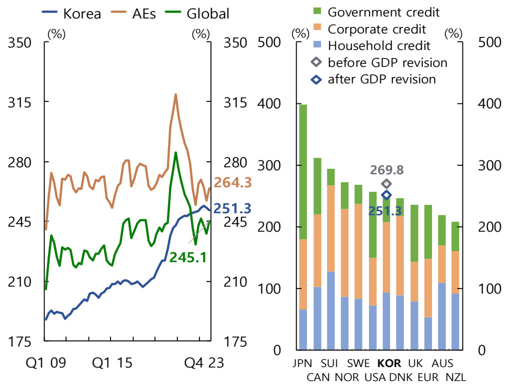
Major Financial Stability Risk Assessment

As highlighted, Korea's financial system remains predominantly stable amidst the economic recovery. Private sector credit leverage has reduced and credit concerns in the financial market have eased due to narrower credit spreads. Financial institutions have maintained favorable resilience in terms of capital adequacy and liquidity. Moreover, concerted efforts by the government, supervisory authorities, and Bank of Korea have effectively managed uncertainties. Measures have been implemented to facilitate a smooth adjustment in the recent real estate PF sector and mitigate potential spillover risks from geopolitical developments into the domestic financial market.

However, in the short-term, risks persist, including the mounting debt repayment burden in vulnerable sectors[3] and concerns over the stability of the real estate PF loans[4]. These factors could potentially degrade the asset quality of financial institutions[5] and the heightened uncertainty surrounding external conditions[6], such as the monetary policy stances in major economies. Looking ahead to the medium- to long-term, there are potential risks of increasing financial vulnerabilities, notably the possibility of renewed household debt accumulation amid still high private credit leverage. This financial stability report evaluates the macro leverage landscape in light of these vulnerabilities within Korea' s financial system, and also assesses systemic risks using the newly developed stress test model of Bank of Korea (SAMP 2.0).

Firstly, examining macro leverage, which refers to the volume of debt in the household, corporate, and government sectors comprising the macro economy, relative to the nominal GDP in Korea, the report documents that the level is higher than the global average but lower compared to advanced countries. However, private sector credit, including households and corporations, shows a higher level compared to advanced countries due to the expanded credit supply in the real estate sector. In terms of the quality of macro leverage, its risk to financial stability is currently not significant, as the debt servicing capacities of indebted households are favorable and overall financial conditions for businesses remain stable. Nonetheless, it is important to note that the household debt repayment burden exceeds that of advanced economies and there has been an increase in the proportion of debt held by companies with relatively weak debt repayment capacities.[7]

Macro leverage trend and comparison of macro leverage[1] by country



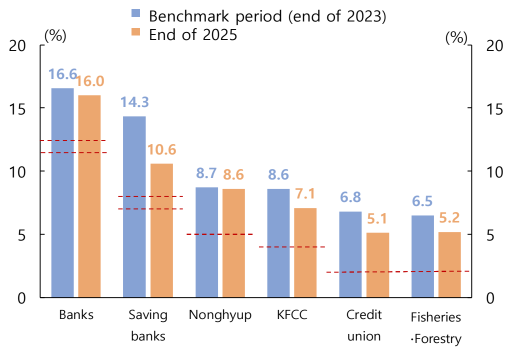
Note: 1) As of end-Q4 2023
Source: Bank of Korea, BIS

Next, Bank of Korea completely rebuilt its Systemic Risk Assessment Model for Macroprudential Policy

3) For further details, refer to "Box 1. Recent Trends of Household and Self-Employed Loans and Characteristics of Changes in the Default Rate."
4) For further details, refer to "Box 2. Current Status of Real Estate PF-related Financial Exposure and Risk Review."
5) For further details, refer to "Box 3. Factors Behind Changes in Profitability of Banks by Interest Rate Levels and Major Future Considerations" and "Box 4. Assessment of Asset Quality of Non-bank Deposit-Taking Institutions and Implications."
6) For further details, refer to "Box 5. Comparison of Domestic and External Conditions Between the Second Half of 2022 and the Recent Period of the Currency Depreciation."
7) For further details, refer to "Analysis of Major Issues Ⅰ. Review of the Financial System' s Potential Risks Through Macro Leverage Assessment."

(SAMP) this year, which has been pivotal in conducting stress tests for banks and non-bank financial institutions since 2012, enabling a more systematic estimation of financial institution credit risks using micro data[8]. The Bank formulated scenarios that account for recent changes in the domestic and global macro-financial and economic environment, including risks related to real estate PF-related credit risks, geopolitical conflicts. Using this newly rebuilt model, the Bank conducted stress tests to assess the impact of severe shocks on vulnerable sectors within individual financial institutions. The results of these stress tests indicate that financial institution capital adequacy ratios generally exceed regulatory standards, even under scenarios of macroeconomic stress. However, there is concern over resilience of some vulnerable non-bank deposit-taking institutions, which could deteriorate significantly. Given their limited weight and interconnectedness within the financial system, the likelihood of their defaults escalating into systemic risk is considered low. Nevertheless, it is necessary to strengthen the soundness of management in non-bank deposit-taking institutions.[9]

Changes in capital adequacy ratios for banks,[1] savings banks,[2] and mutual credit coopreratives[3] when applying scenarios



Notes: 1) Banks: based on the BIS total capital ratio, regulatory standard (including countercyclical capital buffer) of 11.5% (12.5% for D-SIBs).
2) Savings Banks: based on equity/risk-weighted assets, regulatory standard 7%(8% for assets over KRW 1 trillion)
3) Mutual credit cooperatives: based on the net capital ratio, regulatory standard (5% for National Agricultural Cooperative Federation(Nonghyup), 4% for MG Korean Federation of Community Credit Cooperatives(KFCC), 2% for Credit Union, Fisheries and Forestry Cooperatives).

Source: Bank of Korea, financial institutions' business reports.

Policy Recommendations

Firstly, the government and supervisory authorities need to facilitate an orderly restructuring process by effectively implementing the recently announced measures for a soft landing in real estate project financing (PF). This initiative aims to mitigate uncertainties associated with real estate PF. During this process, it is crucial to enhance communication with construction companies and market participants to prevent unexpected instability in the financial market.

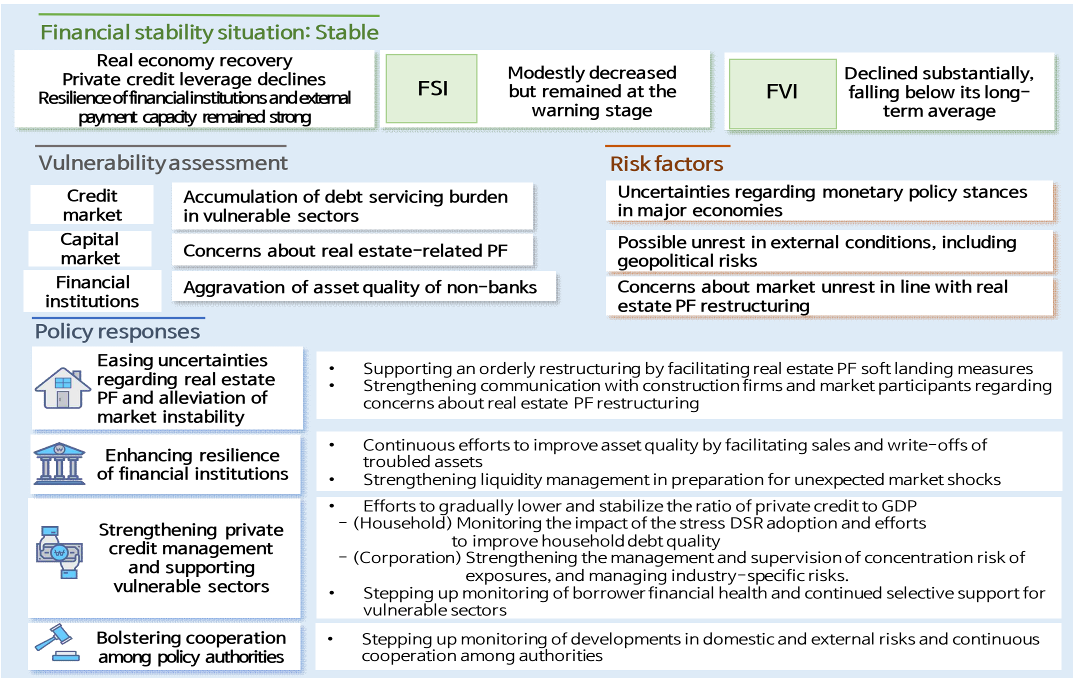
8) The Bank of Korea and the Financial Supervisory Service signed an MOU to share financial data about non-bank deposit-taking institutions (October 30, 2023), agreeing to expand information sharing about savings banks, credit unions, agricultural cooperatives, and fisheries cooperatives and forestry cooperatives, and to step up monitoring for policy coordination. Since then, access to micro data, such as financial institution borrower information, has been enhanced and thus this data has been used to re-build the stress test models.

9) For further details, refer to "Analysis of Major Issues Ⅱ. Rebuilding of Stress Test Models Based on Micro Data and Examination of Financial Institution Resilience."

Next, given the deteriorating asset growth evidenced by increasing loan delinquency rates across most financial sectors, financial institutions should intensify efforts to improve asset quality. These efforts should include bolstering loss-absorption capacity and actively promoting the write-offs and sales of non-performing assets. Specifically, non-banking sectors, such as savings banks and mutual credit cooperatives, need to enhance liquidity management, given their relatively weaker liquidity response capabilities during unexpected stress situations.[10)]

Furthermore, policy authorities and financial institutions need to continue efforts to gradually stabilize and lower private sector credit leverage. Regarding household credit, it is essential to secure policy effectiveness by monitoring the impacts of the stress DSR introduced this February and evaluate the appropriateness of the DSR scope, along with efforts to improve the quality of household debt. For corporate credit, which has recently expanded rapidly, financial institutions should implement industry-specific risk management thoroughly.

Bank of Korea will strengthen monitoring of developments in internal and external risk factors to ensure effective policy responses for financial stability. The Bank also will collaborate closely with policy authorities to timely implement market stabilization measures in the case of unexpected market instability.



10) For further details, refer to "Box 6. Liquidity Stress Test Results of Non-bank Financial Institutions."