Financial Stability Report

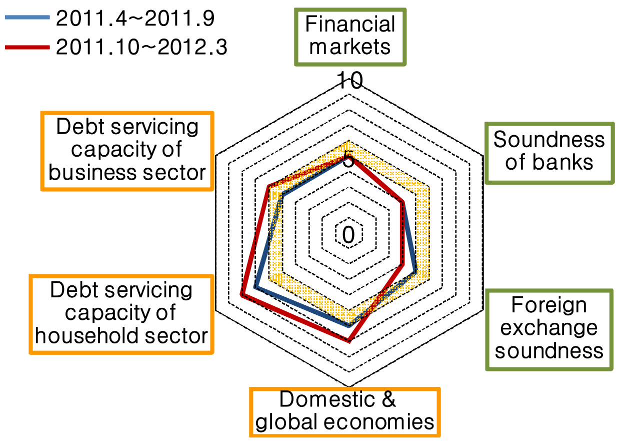
April 2012

The following is an English translation of the overview in the Financial Stability Report. The full English version will be published in May 2012.

The Bank of Korea

Overview

Financial stability map[1)2)]



Notes: 1) The closer to the center, the greater the degree of stability.
2) □ Financial system dimensions
□ Financial stability condition dimensions

The financial system remained generally stable, although conditions at home and abroad worsened due mostly to the accumulation of household debt and the fallout from the sovereign debt crisis in Europe. The resilience of the financial system was heightened, as the soundness of banks, which make up the backbone of the financial system, improved, boosted by large-scale net profits, and as foreign exchange soundness also remained on a trend of improvement thanks to the effects of steps taken to enhance macroprudential soundness, including imposition of the Macroprudential Stability Levy on foreign exchange non-core deposits. In addition, the volatility of financial market price variables stabilized at a low level. This stable state of the financial system is well-represented in the financial stability map.[1)]

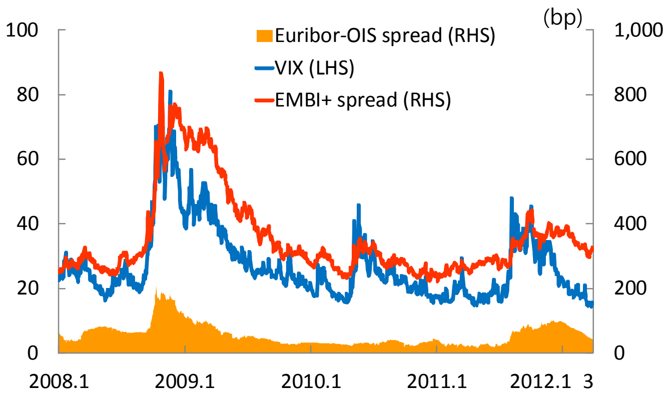
Policy efforts will have to be strengthened to maintain financial system stability more firmly. Inasmuch as financial system resilience is secured only when economic fundamentals are kept on a sound course, the Bank of Korea will conduct its monetary policy in such a way as to anchor the basis for price stability over the medium-term horizon amid continuing sound growth of the Korean economy. The relevant policy authorities should strive to devise policy options to stabilize household debt, implement bold restructuring of marginally viable firms, enhance banks' shock absorption capacities, and so forth.

1) The financial stability map presents a comprehensive picture of stability in a total of six dimensions—three concerning the financial system (the financial markets, soundness of banks and foreign exchange soundness) and three on financial stability conditions (the domestic and global economies, debt servicing capacity of the household sector and debt servicing capacity of the business sector). If the decile reading of a particular dimension is 5-6, this may be seen as the degree of stability of that dimension corresponding to its average levels in the past (since 1995). For a detailed explanation, refer to <Box II> 「Outline of Korea's Financial Stability Map」.

[Macroprudential Conditions]

1 In the international financial markets, instability appears to have eased since the beginning of 2012, on the back mostly of the progress made in discussions on resolving the sovereign debt problems in Europe and the ongoing expansive monetary policy stances on the parts of the ECB and other central banks of major countries. As the tendency toward risk aversion has moderated in line with the ample global liquidity, the VIX, an indicator of global financial market volatility, has maintained a downward trend and the EURIBOR-OIS spread, a measure of credit risk in the European money markets, has also narrowed.

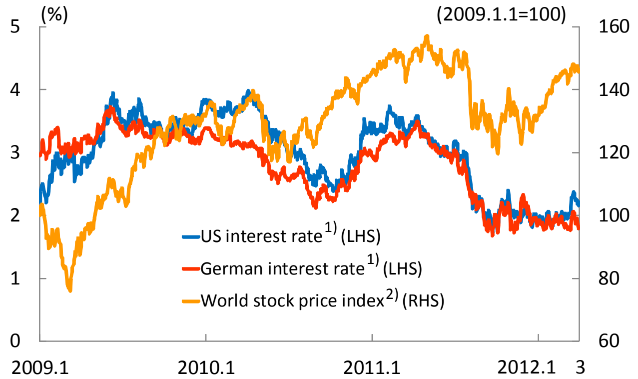
VIX, EMBI+ spread, and Euribor–OIS spread



Source: Bloomberg

Long-term interest rates in major countries have remained at low levels, after falling sharply in August 2011 on concerns about a weakening of the business recovery, but more recently they have risen slightly. Stock prices shifted to an uptrend upon the ECB's supply of long-term liquidity in December 2011 and the consequent soothing of market unrest.

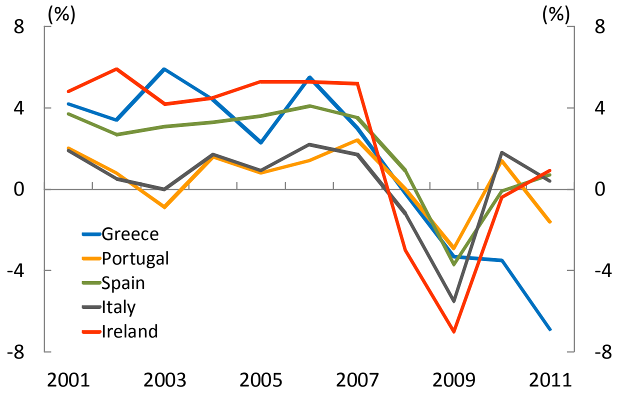
Interest rates and stock prices in major countries



Notes: 1) Based on 10-year bonds
2) Based on the MSCI index
Source: Bloomberg

There is a possibility of the European sovereign debt crisis becoming prolonged, however, since the debt repayment burdens of overly-indebted nations other than Greece remain as before, and since the economic recoveries in these countries and their implementations of fiscal retrenchment plans as well are still unclear. In addition, given that there is also a likelihood of European banks stepping up their deleveraging in the course of complying with the upwardly-adjusted capital adequacy requirements, concerns linger that the international financial markets could again grow uneasy depending upon the manner in which the European sovereign debt crisis unfolds.

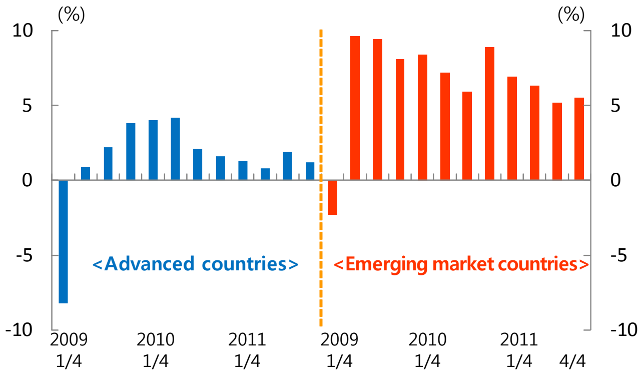
GDP growth rates
of overly-indebted European countries



Source: EU Commission

2 World economic growth is slowing, as the business recoveries in advanced countries weaken and the impacts from this spread to the emerging market countries.

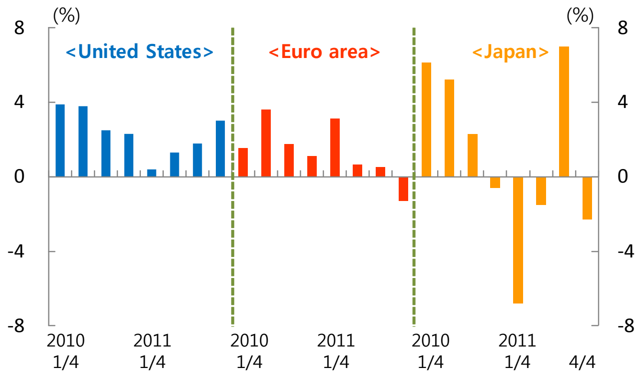
GDP growth rates[1)]
of advanced and emerging market countries



Note: 1) Annualized quarter-on-quarter rates
Source: IMF WEO (Jan 2012)

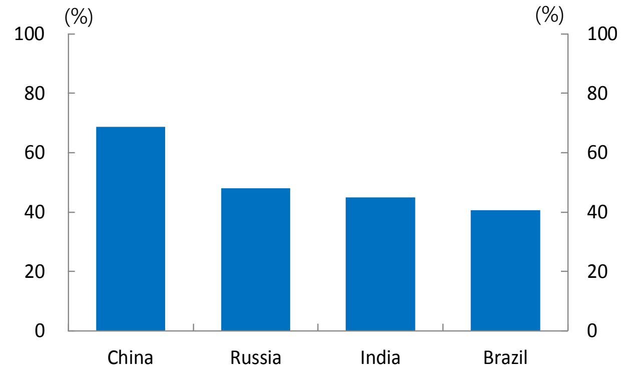
The US economy is sustaining a moderate trend of recovery, helped mostly by an increase in corporate investment. However, factors such as the increase in the long-term unemployed, the continued housing market slump, and worries over snags in the pursuit of fiscal consolidation are preventing the recovery from gaining traction. The euro area economy appears set on a low growth path for a considerable time, as the effects of the sovereign debt crisis feed through to the economies of core euro area countries including Germany by way for instance of financial market unrest and the waning confidence of economic agents.

GDP growth rates[1)] of major advanced economies



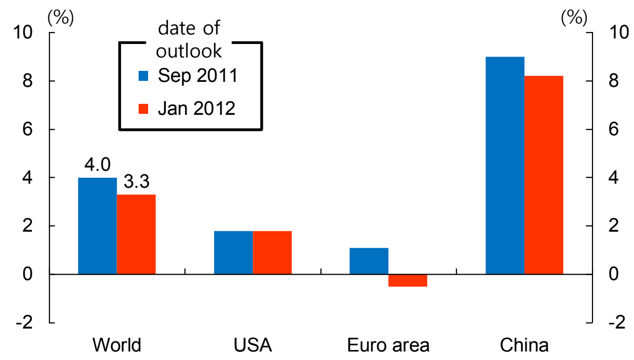
Note: 1) Annualized quarter-on-quarter rates
Source: Bloomberg

The economies of emerging market countries, including China, have seen their paces of growth slacken markedly since the second half of 2011, due to the deteriorating export climate brought about by the weakening trends of recovery in advanced economies. There are concerns about growth slowing in the coming months as well, owing mostly to continuation of the low growth trend of the euro area economy and to an additional run-up in international oil prices.



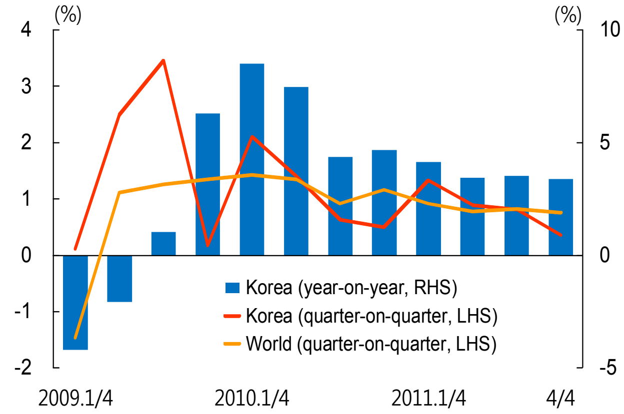
Note: 1) Based on Jan–Sep 2011 figures
Source: IMF

Going forward the world economy will exhibit a modest trend of recovery, but there are a number of downside risks present, including those of a weakening of the business recovery momentum of advanced economies, of a further increase in international oil prices in response to geopolitical risk, and of disruptions to the restoration of fiscal soundness in major countries.



Source: IMF WEO (Jan 2012)

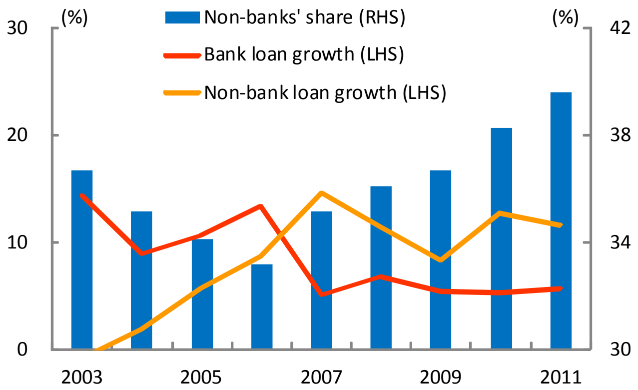
3 In the Korean economy, the trend of growth appears to be slackening, owing chiefly to the continued uncertainty as to external conditions and the consequent erosion of investment and consumer confidence. The domestic economy is expected to post quarter-on-quarter growth rates of around 1% in the first half of 2012, pulling out of its sluggishness during the fourth quarter of 2011. It is forecast to then show a rising trend from the second half onward, albeit modestly, as external uncertainties moderate. Uncertainty as to the growth path remains, however, stemming mostly from the run-up in international oil prices and slowing growth in China and other emerging market countries.



Sources: Bank of Korea, IMF WEO (Jan 2012)

4 Household debt is continuing to rise, led by non-bank lenders and low-income borrowers. The possibility of household loans turning sour on a large-scale in the short term does not seem high, however, given that the overall level of delinquency rates on household loans is still low (for banks: 0.7% as of year-end 2011) and that the loan-to-value (LTV) ratios of mortgage loans are also low.

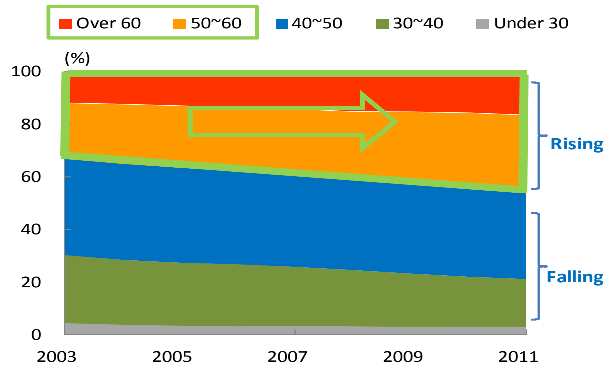
Household lending growth rates, by financial sector, and non-banks' share of household loans



Source: Bank of Korea

Meanwhile, in line with the mounting debts of borrowers in the low income brackets, amid the intensifying polarization of household incomes, the risks of these households with their low debt servicing capacities going into distress could rise. Moreover, household lending to borrowers in the high-age cohort above 50 years of age, who are beginning their retirements, is increasing sharply. And since their income generating capacities are weak these borrowers could encounter serious difficulties in repaying their debts in the event of a shock such as a decline in housing prices.

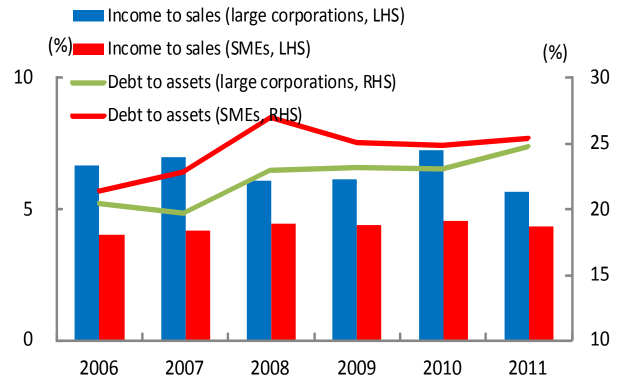
Shares[1)] of household loans, by age cohort



Note: 1) Loans by age cohort / total loans (including household loans of banks and non-banks)
Source: NICE

5 In the corporate sector, financial soundness is found to have declined on the whole, with profitability falling and cash generating capacity also weakening due to the slowdown in world economy activity and to lackluster domestic demand.

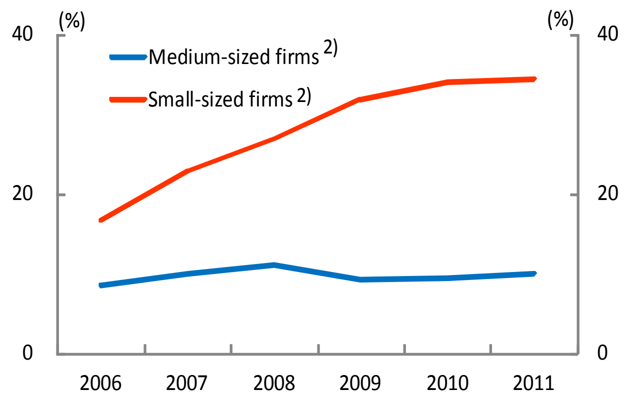
Income-to-sales and debt-to-assets ratios



Source: KIS-Value

With the business performances of small-scale firms deteriorating greatly, particularly centering around those in the real estate & rental and restaurant & lodging businesses, the number of marginally viable firms is increasing rapidly. Should business activity remain subdued in the coming months as a consequence, there are fears of a rising risk of insolvencies, concentrated on marginally viable firms.

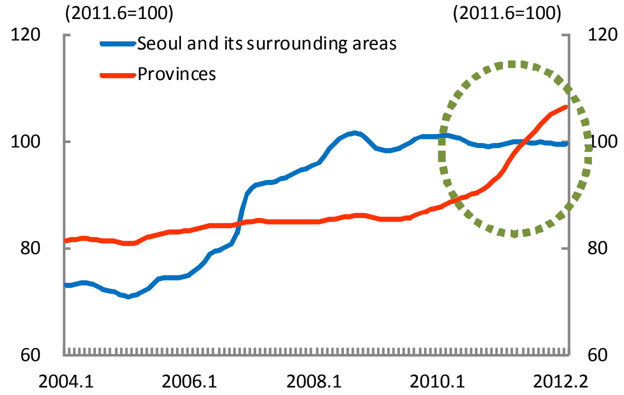
Proportions of marginally viable firms[1], by size



Notes: 1) Marginally viable firms are companies that have during the last three consecutive years had either net interest coverage ratios below 100% or negative operating cash flows.
2) Medium-sized firms are those with sales of 10 billion won or more, and small-size firms those with less than 10 billion won in sales.
Source: KIS-Value

6 In the real estate market, the divergent movements across regions continued, with housing prices appearing to weaken in Seoul and its surrounding areas, centering around large housing units, while in contrast exhibiting a steep upward trend in the provinces. This rapid housing price rise in the provincial areas is considered to have been attributable mainly to a contraction in the supply of available housing and to the translation of demand for housing on a leasehold deposit basis into demand for outright purchases following the steep run-up in leasehold deposit prices.

Housing purchase price indices, by region[1]

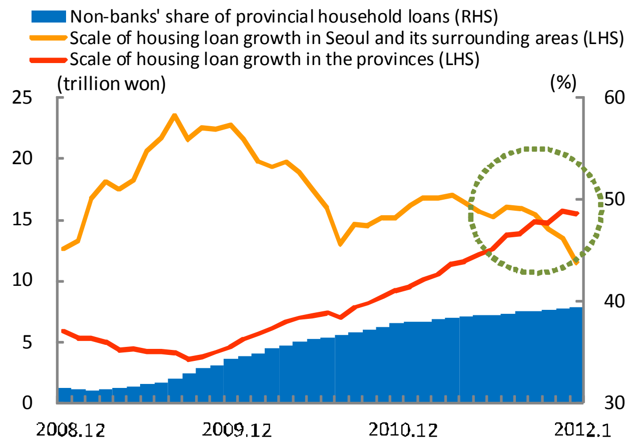


Note: 1) The index for the provinces is the simple average of the indexes for the five metropolitan cities and other provincial regions.
Source: Kookmin Bank

Downside risks to housing prices in Seoul and its surrounding areas predominate, including the limitations on incomes due to the business slowdown and the weakening of home-buying sentiment. Under these conditions, housing prices could fall steeply in a short period of time in case of any unexpected shock. There are therefore fears in such a case about insolvencies among households that have borrowed excessively relative to their incomes in anticipation of prices rising.

The household debts of borrowers in the provinces have been increasing, centering around those owed to the non-banking sector, in tandem with the huge rise in housing prices there. The household debt problem appears as a consequence to be spreading from the Seoul metropolitan area to the provinces, and from the banking to the non-banking sector.

Housing loan growth[1], by region, and non-banks' share of provincial housing loans

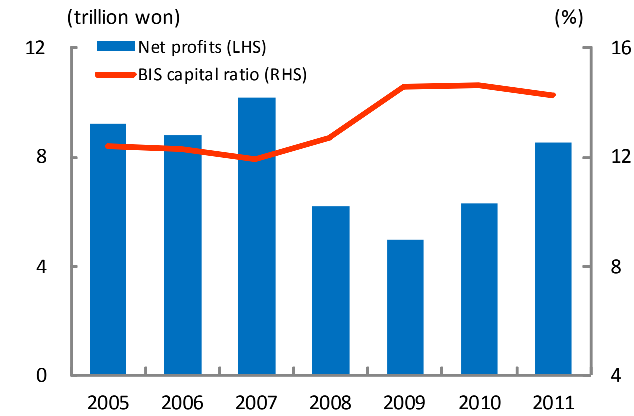


Note: 1) Year-on-year basis (total for banks and non-banks)
Source: Bank of Korea

[Financial system stability assessment]

7 In the banking sector, asset soundness has been enhanced by the large-scale sales and write-offs of troubled assets amid smooth funding conditions. In addition, as profitability has improved, capital adequacy has also maintained a comparatively favorable level.

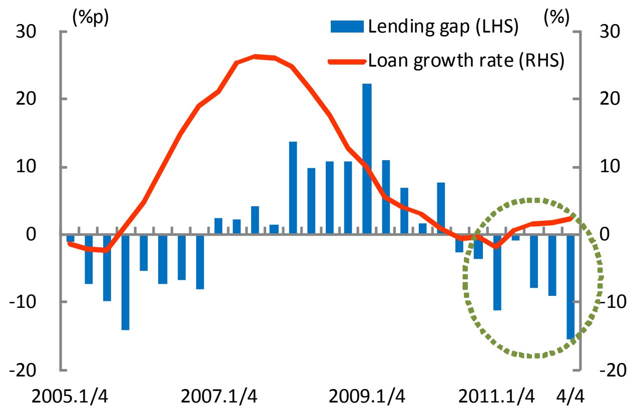
Commercial banks' net profits & BIS capital ratio



Source: Commercial banks' business reports

On the asset side, lending to large corporations has increased by a large margin but that to SMEs remained lackluster. This is seen as a result of the conservative attitudes toward extension of loans to SMEs with low credit ratings.

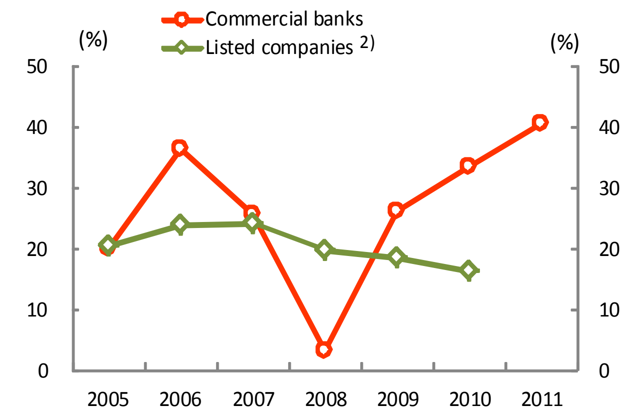
SME loan growth[1] and lending gap[2]



Notes: 1) Year-on-year rates of growth
2) This gap is the difference between the ratio of SME loans to nominal GDP and its trend value.
Sources: Bank of Korea, commercial banks' business reports

Domestic banks' efforts to boost their shock absorption capacities by retaining profits are on the other hand seen as having fallen short, as they have posted high dividend payout ratios in comparison with those of listed domestic firms and banks in major emerging market countries.

Commercial banks' dividend payout ratio[1]

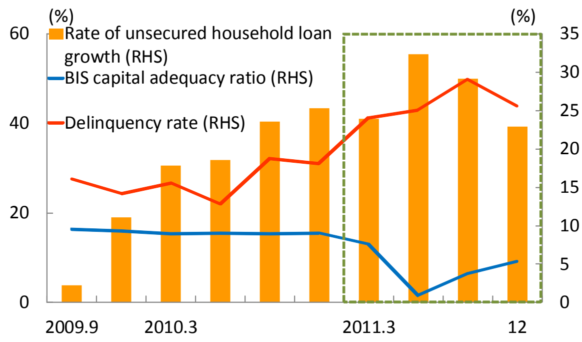


Notes: 1) Dividends paid / net profits (after loan loss provisioning)
2) Based on companies listed on the KOSPI whose books close at end-December
Sources: Commercial banks' business reports, The Korea Listed Companies Association

8 In the non-banking sector, there are concerns about a deterioration of management soundness in certain sub-sectors.

Mutual savings banks are experiencing difficulties because of their lackluster business performances. In the event of a further souring of real estate project financing (PF) loans coupled with deterioration in the soundness of unsecured household loans, which have recently been surging, insolvency problems at savings banks could once again come to the fore.

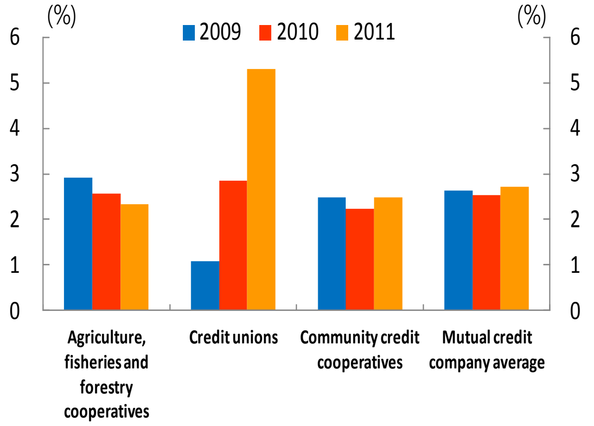
Rates of unsecured household loan growth[1], delinquency and BIS capital adequacy



Note: 1) Year-on-year rates of growth
Source: Financial institutions' business reports

The household loans of mutual credit companies (agricultural, fisheries and forestry cooperatives, credit unions and community credit cooperatives) are increasing rapidly, influenced for instance by the banking sector's reining in of its household lending. There is a possibility of these loans becoming distressed on a large scale if the improvement in household incomes is delayed, since some mutual credit companies are showing signs of worsening asset soundness.

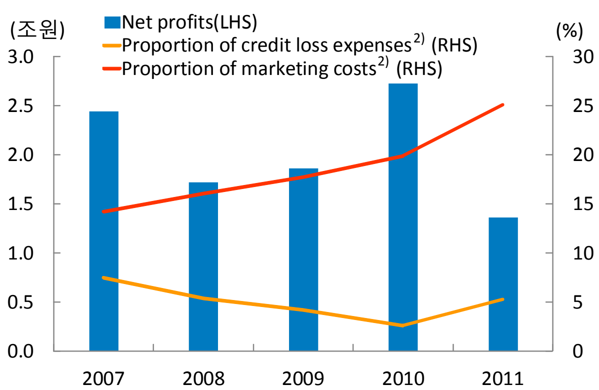
Proportions of loans classified as precautionary



Source: Financial institutions' business reports, the relevant federations

Credit card companies' management soundness looks favorable overall, although their profitability and asset soundness have worsened to some degree. The quality of their assets could however deteriorate in the future, owing to a worsening of card holders' credit conditions, and their profitability could decline due for instance to their increased marketing costs arising from the intensified competition among them.

Credit card company profitability[1]

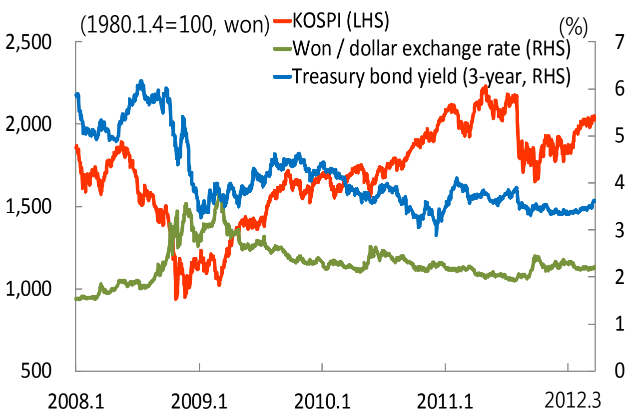


Notes: 1) Excluding Kookmin Card
2) Loan loss provisions / income from card business
3) Marketing expenses / income from card business
Source: Financial institutions' business reports

9 The Korean financial markets have presented a relatively stable picture, with reduced price variable volatility for example, as the international financial market unrest has eased entering 2012.

Treasury bond (3-year) yields have been fluctuating within a narrow range at around the mid-3% level, influenced chiefly by global financial market conditions and foreign investor transactions. The main stock price index (KOSPI) fluctuated, after having fallen sharply from August 2011 in response mostly to the US sovereign credit rating downgrade and the resurfacing of the euro area sovereign debt crisis, but then shifted to an upward track from the beginning of 2012. The won/dollar exchange rate showed an upward trend from September 2011, due to the international financial market unrest, but has since early 2012 maintained a downward trend by and large.

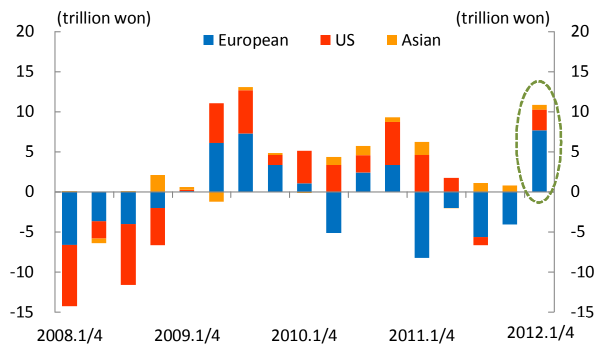
Interest rate, stock price and exchange rate



Source: Bank of Korea

In the stock market, rapid inflows of Europe-based short-term stock investment funds, which are particularly sensitive to the European sovereign debt problem, have recently been observed. There are as a consequence concerns about the volatility of price variables such as interest rates, stock prices and the exchange rate rising, should large outflows of foreigners' portfolio investment funds occur in the event of domestic or external shocks.

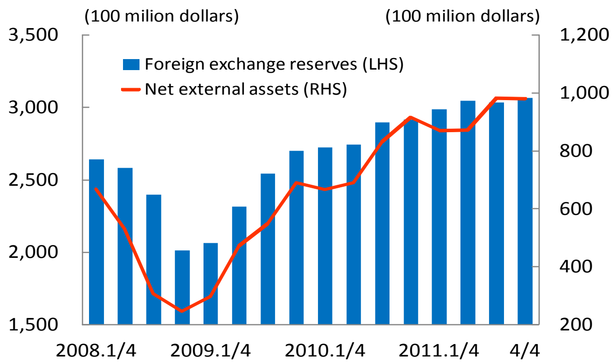
Foreigner stock investment funds, by nationality



Source: Bank of Korea

10 Foreign exchange soundness appears favorable on the whole, with foreign exchange reserves and net external assets increasing and the external debt servicing capacity rising.

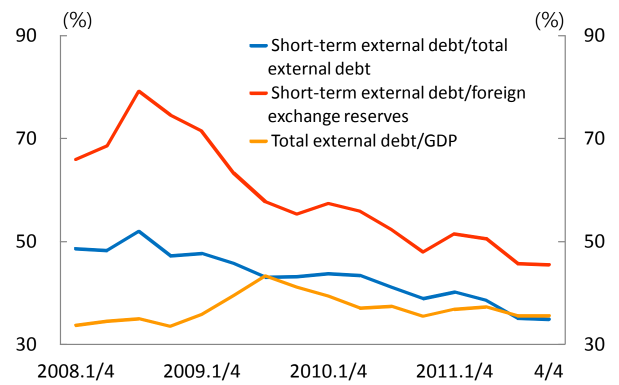
Foreign exchange reserves and net external assets



Source: Bank of Korea

The ability to repay short-term external debt has been enhanced, as the ratio of short-term external debt to foreign exchange reserves has declined, while the ratio of total external debt to GDP, indicative of a nation's external debt servicing capacity, has been maintained at a stable level. Meanwhile, with the fall in short-term external debt the external debt profile has also improved, as seen for instance in the declining weight of short-term in total external debt.

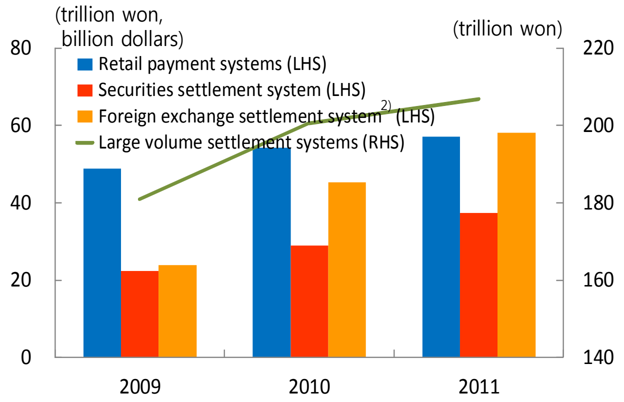
External debt servicing capacity
and liquidity indicators



Source: Bank of Korea

11 The payment and settlement system operated stably on the whole during 2011. In particular, risks in the securities and foreign exchange settlement systems stemming from mismatches in settlement times declined, as the proportions of settlement made through delivery-versus-payment (DVP) and payment-versus-payment (PVP) systems steadily rose.

Amounts[1] settled,
through major payment and settlement systems



Notes: 1) Daily average basis
2) Amount settled through CLS Banks' payment-versus-payment (PVP) system (gross amount basis, before multilateral netting)
Sources: Bank of Korea, Korea Financial Telecommunications and Clearings Institute, Korea Exchange, and Korea Securities Depository

[Policy responses and challenges for financial stability]

12 In response to the mounting uncertainties at home and abroad, the Bank of Korea prepared a wide range of policy initiatives for the maintenance of financial system stability and pursued them actively.

As a first step, the Bank of Korea sought to heighten the macroprudential soundness of the foreign exchange sector. It took measures, in consultation with the government, to alleviate capital flow volatility —including those lowering the ceilings on the forward exchange positions allowed at foreign exchange banks and restricting institutions handling foreign exchange business in their investment in foreign currency-denominated bonds issued domestically for Korean won funding purposes. The relevant regulations were in addition realigned to facilitate seamless implementation of the Macroprudential Stability Levy. Along with this, in order to heighten the capacity for responding to overseas shocks, the currency swap arrangements with Japan and China were also enlarged.

13 Although Korean financial system stability is being maintained, thanks mostly to the policy efforts of the Bank of Korea and the government, latent risk factors are as ever present—including the possibility of the euro area sovereign debt crisis resurfacing, the existence of downside risks to the world economy, and the accumulation of household debt. Policy efforts, as set out below, must therefore be strengthened to secure the stability of the financial system still more firmly.

14 The Bank of Korea intends to augment its capacities for advanced identification of systemic risk and provision of early warnings. Based upon these capabilities, it will move to further strengthen the framework of policy cooperation among the authorities concerned. Given that financial system resilience is secured only when economic fundamentals are maintained at sound levels, it will conduct monetary policy so as to firmly anchor the basis for price stability over the medium-term horizon amid continuing sound growth of the Korean economy. The government must meanwhile endeavor to maintain fiscal soundness by strict budgetary discipline, with a view toward securing sufficient policy latitude for coping with any unexpected shocks.

15 There is a need to strengthen efforts to improve the situation of the low income groups, for example through job creation, so that the weakening of their debt servicing capacities does not lead to household debts going bad on a large scale. To prevent the loans of the high-age cohorts from turning sour as a result of the increase in their household debt, multi-faceted schemes should in addition be devised, including an expansion of employment opportunities for members of these cohorts.

16 To remove the lingering uncertainty in the financial markets in connection with SME credit risk, swift and bold restructuring of marginally viable firms must be accomplished. To this end, there is a need for the prime banks of these enterprises to strengthen the system for the ongoing restructuring of these enterprises.

17 Banks must reinforce their recapitalization drives in preparation for unforeseen domestic and external shocks. The supervisory authorities need in this regard to direct banks lacking capital buffers adequate for the absorption of shocks to increase their profit retention rates.

Foreign currency liquidity conditions for Korean banks could deteriorate if European-based financial institutions proceed with large scale deleveraging, in line for instance with the euro area sovereign debt crisis. The policy authorities concerned must therefore see to it that international financial market unrest does not spill over to the domestic financial markets, by for example attentive monitoring of banks' foreign currency liquidity conditions.

18 Mutual savings banks must strengthen their recapitalization and other self-rescue efforts, so as to regain the markets' confidence and soothe customers' unease. In the cases of credit card companies and mutual credits, on the other hand, whose assets have recently grown steeply, the supervisory authorities should strengthen their oversight and supervision of the excessive competition to expand their sizes among these institutions.

19 Closer monitoring is required in respect of speculative short-term capital flows, in order to forestall any reduction of foreign exchange soundness triggered by large-scale in- and outflows of foreigners' funds. Moreover, the macroprudential policies in the foreign exchange sector for easing capital flow volatility need to be operated flexibly, in accordance with evolving conditions. Besides this, while policy efforts to improve the foreign debt profile are on the one hand continued, there is a need as well to work to fortify the framework of international policy cooperation, by way for example of augmentation of the global and regional financial safety nets, given the limits that exist on the extent to which foreign exchange soundness can be enhanced by foreign exchange reserve holdings alone.