Executive Summary

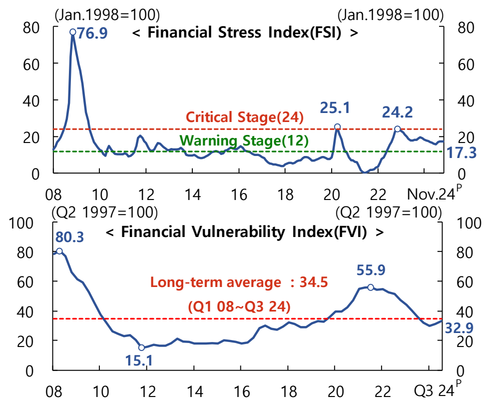
Financial Stability Situation Assessment

Korea's financial system has recently experienced increased volatility in financial and foreign exchange markets due to heightened uncertainties both domestically and internationally. Nevertheless, it has generally remained stable, given the sound resilience of financial institutions and external payment capabilities. However, attention should be paid to the heightened market volatility stemming from domestic and international uncertainties, as well as the ongoing accumulation of medium- to long-term financial imbalances during the monetary policy easing process.

Since the second quarter of this year, housing prices have been rising, particularly in the Seoul metropolitan area, and household debt has been increasing steadily, as expectations of a Base Rate cut have been priced into market interest rates. This trend intensified further during July and August, leading to an expansion in financial imbalances. In response, Bank of Korea decided to keep the Base Rate unchanged in August to prioritize financial stability, despite the conditions for a rate cut being met in terms of inflation and the real economy. Meanwhile, the government and supervisory authorities proactively strengthened macroprudential regulations. As a result of this coordinated policy approach, the growth of household debt and the upward trend in housing prices have slowed since September. Meanwhile, financial institutions have maintained a robust level of resilience, although delinquency rates on households and corporate loans rose, particularly in non-bank sectors. Nonetheless, domestic financial and foreign exchange markets continue to display elevated levels of volatility.[1]

Reflecting these conditions, the Financial Stability Index (FSI)[2], which comprehensively indicates the short-term instability of the financial system, remained in the warning stage, standing at 17.3 in November 2024. Meanwhile, the Financial Vulnerability Index (FVI)[3], which measures medium- to long-term financial vulnerability, rose to 32.9 in the third quarter of 2024, compared to 29.6 in the first quarter. However, it still remains below its long-term average of 34.5, calculated since 2008.

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



Notes: 1) The index value may fluctuate in the future due to the parametric variability.
Source: Bank of Korea

1) Bank of Korea held an emergency meeting of the Monetary Policy Committee on December 4th to address potential instability in the financial and foreign exchange markets. It announced that it would keep all options open and actively implement market stabilization measures until the market stabilizes. Specifically, the scope of repurchase agreement (RP) purchases, including eligible securities and institutions, was temporarily expanded, and non-standard RP purchases were conducted to increase short-term liquidity supply. Additionally, the government prepared a securities market stabilization fund worth up to 10 trillion won and activated a total of 40 trillion won in bond market stabilization funds, corporate bond purchases, and RP purchase programs.

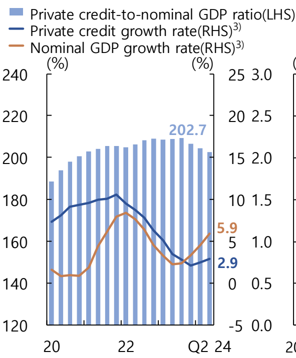
2) The FSI is a comprehensive index (0-100), that is calculated by normalizing 20 monthly stress indicators of the real economy and financial sectors. The thresholds for the 'warning' and 'crisis' stages are set at 12 and 24, respectively, based on the noise-to-signal method. For details, refer to <Box 7> "Results of Financial Stress Index (FSI) Reform," Financial Stability Report, December 2023.

3) The FVI is a comprehensive index (0-100), that is calculated by normalizing 39 indicators related to three assessment factors: asset prices, credit accumulation, and financial system resilience.

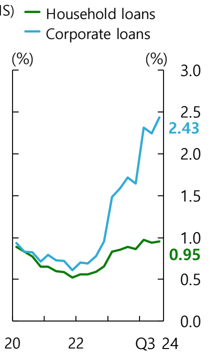
Financial Stability Situation by Sector

Looking at vulnerabilities in Korea's financial system by sector, household loans in the credit market expanded, driven primarily by the banking sector and mortgage loans. However, their growth slowed following the implementation of strengthened macroprudential regulations in August. The delinquency rate on household loans also has shown signs of moderation, supported by a reduction in debt burden of household.[4] Meanwhile, growth in corporate loans slowed, particularly among non-bank financial institutions and SME loans, but delinquency rates for these loans continued to increase. While the growth and profitability of corporations, particularly large enterprises, improved compared to the end of last year, enhancing their debt repayment capacity, the disparity in performance between large enterprises and SMEs widened further.

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



Delinquency Rates on Household and Corporate Loans



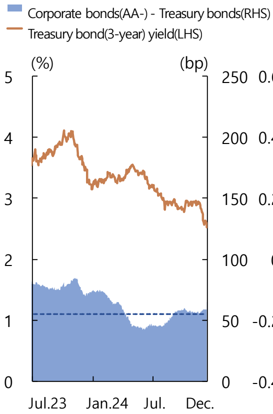
Notes: 1) Based on flow of funds statistics.
2) Sum of nominal GDPs for the given and three preceding quarters.
3) Year-on-year basis.
Source: Bank of Korea, Financial Institutions' business reports

In asset markets, volatility has modestly increased, driven by declines in market interest rates and stock prices resulting from shifts in the monetary policy stances of major economies, policy uncertainty surrounding the U.S. presidential election, and trends in domestic and international inflation and economic indicators. Meanwhile, credit spreads on corporate bonds remained around their long-term average levels, with moderate fluctuations. Housing sales prices, particularly in the Seoul metropolitan area, rose significantly until August, however, the pace of increase slowed thereafter due to the government's strengthened household loan management policies and financial institutions' enhanced risk management measures. In contrast, leasehold deposits and monthly rents continued their moderate upward trend. In the commercial real estate sector, a divergence persisted: office rents continued to increase, whereas rents for retail stores continued to decline.

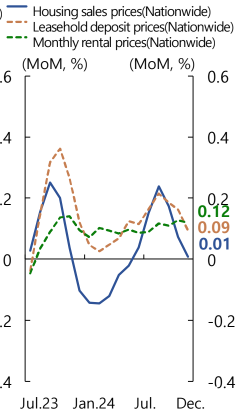
The soundness of financial institutions has somewhat deteriorated, particularly in the non-bank sectors. While banks and insurance companies generally maintained steady asset growth and profitability, non-bank deposit-taking institutions such as mutual credit cooperatives and mutual savings banks experienced weak asset growth and profitability. This was largely due to the reclassification of asset soundness following reassessments of real estate project financing (PF) feasibility and the increased repayment burdens of borrowers. Securities and credit-specialized financial companies continued to expand their assets but experienced a decline in overall profitability. Meanwhile, asset quality deteriorated significantly, with a sharp rise in the substandard-or-below loan ratio of savings banks and mutual credit cooperatives.

4) For further details, please refer to <Box 4> "A recent review of the trends in bank deposit and lending interest rates, as well as changes in the interest repayment burden for borrowers".

Korea Treasury Bond (KTB) Yields and Corporate Bond Credit Spreads

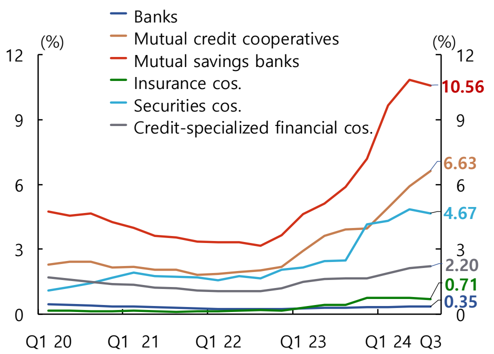


Rates of Increase in Housing Prices



Source: Korea Financial Investment Association, Korea Real Estate Board

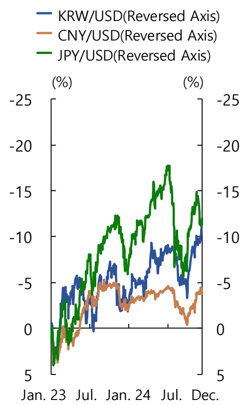
Substandard-or-below Loan Ratio



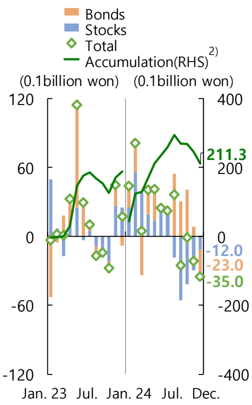
Source: Financial Institutions' business reports

Looking at the external sector, in the foreign exchange market, the KRW/USD exchange rate exhibited increased volatility at a higher level compared to the first half of the year. This was driven by shifts in expectations regarding U.S. Federal Reserve monetary policy, heightened geopolitical risks, increased policy uncertainties both before and after the U.S. presidential election, and domestic political uncertainties. The rise in the exchange rate could slightly weaken the soundness of domestic financial institutions; however, its overall impact is expected to remain limited.5) Meanwhile, portfolio investment in domestic securities by foreigners resulted in a cumulative net inflow across both stocks and bonds. At the same time, residents' overseas portfolio investments expanded in both stocks and bonds, driven by the robust performance of the U.S. stock market and expectations of a U.S. Federal Reserve rate cut.

Appreciation and Depreciation Rates against USD[1)]



Change in Foreigners' Domestic Portfolio Investments



Notes: 1) Appreciation and depreciation rates compared to the end of 2022.

2) Cumulative net inflow amount since January by year.

Source: Bank of Korea, Bloomberg

Resilience of the Financial System

When examining each sector's resilience, which refers to the financial system's ability to withstand domestic and external shocks, financial institutions are found to maintain a sound level of resilience. Although provision coverage ratios have declined due to an increase in substandard-or-below loans across most financial sectors, capital adequacy ratios and liquidity ratios have

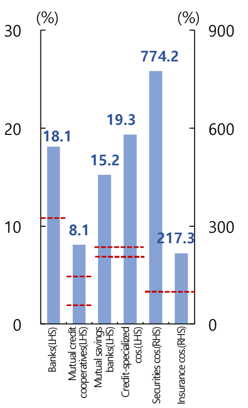
5) For further details, please refer to <Box 8> "The Impact of Exchange Rate Increases on the Financial Soundness of Domestic Financial Institutions".

significantly exceeded the regulatory standards in all sectors.

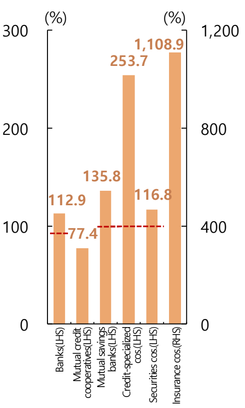
With respect to Korea's external payment capacity, external soundness indicators have generally remained stable, despite a slight decrease in net external assets and an increase in the proportion of short-term external debt.

Meanwhile, payment and settlement systems functioned smoothly as critical components of the financial market infrastructure. The settlement amount on major payment and settlement systems, such as BOK-Wire+, has continued to rise, and settlement risks have been effectively managed.

Capital Adequacy Ratios at Financial Institutions[1)]



Liquidity Ratio of Financial Institutions[1)]



Notes: 1) The red dotted lines represent the regulatory levels for each sector (For the regulatory levels, please refer to 1. Financial Institutions Ⅱ. Resilience of the Financial System.).
2) As of end Q2 2024 for insurance companies.
Sources: Financial institutions' business reports

Major Financial Stability Risk Assessment

As highlighted, Korea's financial system has remained stable overall, but attention should be paid to the impact on financial stability of increasing domestic and external uncertainties. In particular, domestic and international political uncertainties have risen amid a slowdown in real economic growth. Accordingly, Bank of Korea is actively cooperating with the government and supervisory authorities to respond to heightened market volatility, such as fluctuations in exchange rates and stock prices.

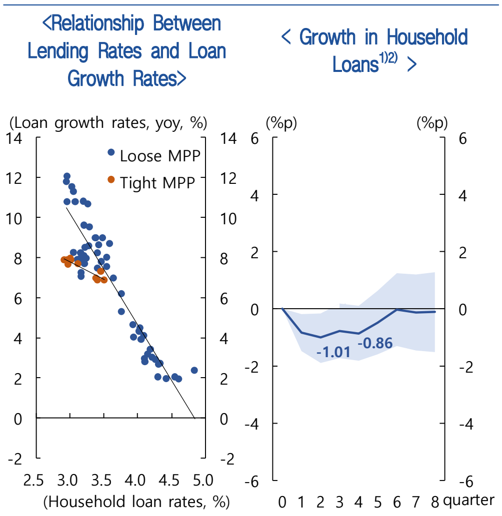
In the short term, attention should be paid to key risk factors such as increased credit risks in vulnerable sectors like the self-employed[6)], concerns about additional defaults in real estate PF[7)], heightened exchange rate volatility, and the potential deterioration in the soundness of financial institutions due to these factors. However, short-term financial destabilizing factors, such as credit risk, are expected to gradually diminish as rate cuts are implemented. Meanwhile, it is critical to examine factors[8)] that may affect the vulnerability and resilience of the domestic financial system from a medium- to long-term perspective. Accordingly, this report examined possible future financial stability risks, such as the accumulation of financial imbalances stemming from changes in economic agents' expectations during the monetary policy easing phase, and assessed the related potential risks in light of recent changes in the quantitative and qualitative structures of household debt.

First, the anlaysis of the financial stability conditions

6) For further details, please refer to <Box 1> "Analysis of Borrower Characteristics and Delinquency Rates in Recent Loans to the Self-Employed".
7) For further details, please refer to <Box 2> "Impact of Real Estate PF Restructuring and Assessment of Related Potential Risks".
8) For further details, please refer to <Box 6> "Impacts and Expected Effects of Korea's Inclusion in the World Government Bond Index (WGBI)".

during the previous rate cut cycles[9] revealed that in the short term, financial stability improved as financial institutions' delinquency rates declined as a result of reduced debt servicing burdens and real economic recoveries. In the medium and long term, however, financial vulnerabilities accumulated as household credit and asset prices rose, and non-bank financial intermediation increased rapidly as risk appetite and search for yield heightened. For the current rate cut cycle, in particular, additional factors, including the earlier reflection of market expectation of interest rate declines and increased domestic and overseas uncertainties, need to be taken into account. The analysis also showed that during the rate cut cycle, financial vulnerabilities may increase due to accelerated household debt growth, but these risks can be mitigated through the preemptive strengthening of macroprudential regulations.[10]

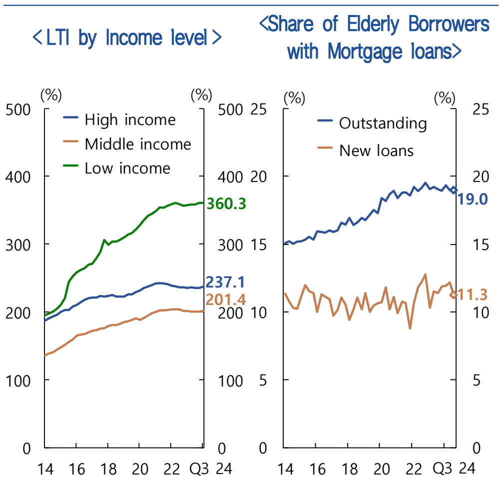
Effects of Tighter Macroprudential Policy (MPP) on Household Lending



Note: 1) Impact of stronger regulations of macroprudential policy on household loan growth.
2) The shaded areas represent confidence intervals at the 95% confidence level.
Source: Bank of Korea calaculation

Next, the analysis of Korea's household debt showed that its structure has undergone changes toward a lower risk of default, including a higher proportion of fixed-rate and amortized loans and a decline in the share of non-bank lending, amid an increase in mortgage loans. However, potential risks persist, such as increased debt reliance among low-income households as household debt rises, and difficulties in achieving smooth deleveraging among the elderly. Estimates of the proportion of delinquent households, reflecting these structural changes, suggested that their shares would rise more steeply among the self-employed and the elderly in the event of income or asset price shocks. This would lead to a reduction in financial institutions' capital adequacy ratios by 0.4 to 1.3 percentage points. However, the likelihood of these credit losses escalating into systemic risks remains limited.[11]

Potential Risks Associated with Korea's Household Debt



Source: Bank of Korea (Household debt DB)

9) The analysis was conducted focusing on the period Q3 2012-Q3 2017 when rate cuts were initiated under similar economic conditions and interest rate levels.

10) For further details, please refer to Analysis of Financial Stability Issues 1, titled "Risks to Financial Stability during Rate Cut Cycles and Their Implications."

Policy Recommendations

Bank of Korea will closely monitor the development of risk factors domestically and abroad to maintain financial system stability. In collaboration with the government, the Bank will adopt a proactive stance by implementing timely market stabilization measures[12] in response to market strains.

The easing of monetary policy restrictions is expected to contribute to reducing credit risks and downside risks

11) For further details, please refer to Analysis of Financial Stability Issues 2, titled "Recent Household Debt Status and Potential Risks."
12) Bank of Korea will closely monitor future conditions in the financial and foreign exchange markets and, if necessary, may consider the following policy measures.

Bank of Korea's Actionable Policy Tools for Stabilizing the Financial and Foreign Exchange Markets

Available Policy Measures		Key Detaiils	Implementation Status as of December 2024
KRW Liquidity Supply	Reduction in Liquidity Absorption Volume	Reduction in the issuance of Monetary Stabilization Bonds and implementation of early redemption, Reduction in RP sales and deposits in the Monetary Stabilization Account	
	Repurchase Agreement (RP) Purchases	Liquidity provision to eligible institutions through RP purchases, Implementation of full-allotment RP purchases with unlimited demand allocation at a fixed interest rate, if necessary	Execution of Non-standard RP purchases in December (Fixed-rate full-allocation RP purchases not implemented)
	Outright Purchases of Government Bonds	Purchases of government bonds in the secondary market to stabilize the bond market	
	Expansion of Eligible Securities and Institutions for Open Market Operations	Additional selection of eligible securities[1] and institutions[2] for RP transactions	Temporarily in operation (December 4, 2024 – February 28, 2025)
	Credit Provision to Financial Institutions and For-Profit Corporations (Articles 64 and 80 of Bank of Korea Act)	Direct lending to for-profit corporations allowed in cases of significant contraction in credit provision by financial institutions	
Foreign Exchange Market Stabilization	Utilization of currency swaps with major central banks	Securing available foreign currency liquidity through the utilization of currency swaps[3] with major central banks	
	Foreign exchange swaps with the National Pension Service	Mitigating supply-demand imbalances in the foreign exchange market via foreign exchange swap	Extension of Duration (Until the End of 2025), Increase in Limit (Billion USD, 500 → 650)
	Limits[4] on banks' forward position holdings	Adjustments to the ceiling on banks' forward position limits (currently 50% for domestic banks and 250% for foreign bank branches) are possible	
	Foreign exchange soundness levy[4]	Temporary reduction of the foreign exchange soundness levy	
	Repurchase agreements for foreign currency-denominated bonds	Provision of USD liquidity by purchasing foreign currency-denominated bonds held by domestic financial institutions under repurchase agreements	
Payment and Settlement Stability	Net Transfer Limits for Financial Institutions	Expanding financial institutions' net transfer limits and implementing measures to expedite collateral arrangements to ensure smooth payment and settlement operations	

Notes: 1) The current eligible securities for open market operations will be expanded to include industrial finance bonds, SME finance bonds, export-import finance bonds, bonds issued by nine public institutions, agricultural finance bonds, fisheries finance bonds, and financial debentures under the Banking Act.
2) The current list of institutions eligible for RP transactions will be expanded to include domestic banks, foreign bank branches, securities dealers, and securities brokers in their entirety.
3) As of December 2024, Bank of Korea has established currency swap agreements with Canada, Switzerland, Japan, and Australia.
4) The government will make decisions through consultation with Bank of Korea and other relevant institutions.
Source: Bank of Korea.

to the economy in the short run. However, if economic agents' expectations for the easing of financial conditions are extreme or last too long, financial imbalances could increase in the medium and long term, with household loans and asset prices rising rapidly. This underscores the importance of an appropriate mix of monetary and macroprudential policies. In addition, since household debt is closely linked to real estate, structural measures to improve househlod debt, such as utilizing REITs for housing finance, must also be pursued in the medium to long term. To improve the debt repayment capacity of the corporate sector, which has faced challenges during the monetary policy tightening, reducing interest burdens as well as boosting operating profits through business condition improvements would be essential. Considering the time needed for these improvements, maintaining favorable financing conditions for temporarily vulnerable firms[13] is crucial. Close monitoring of the corporate liquidity conditions in some sectors affected by external deteriorations will be needed, while continuing efforts toward structural reforms in the corporate sector are necessary, given that structural constraints on domestic firms' exports are expected[14] to have long-term impacts.

To prevent potential domestic and external shocks, such as heightened exchange rate volatility and geopolitical risks, from evolving into systemic risks, financial institutions must consistently enhance their resilience through stronger liquidity and capital adequacy management. In particular, certain depository institutions, such as internet-only banks and savings banks, should secure sufficient liquidity and strengthen their business contingency plans (BCPs) for liquidity management, as these institutions may face liquidity challenges[15] under stress scenarios due to changes in deposit characteristics.

Although household and corporate loan delinquency rates are expected to improve as interest rates are reduced, asset quality at non-bank depository institutions is deteriorating due to rising delinquency rates among household and corporate borrowers. Bank of Korea, in cooperation with other financial authorities, must closely monitor borrowers' debt repayment capacity and financial institutions' loss absorption capabilities. Special attention should also be given to the self-employed, with tailored measures such as financial support, debt restructuring, and reemployment training based on the specific causes of their business challenges.

As financial conditions ease, it is critical to prevent risks from rapidly accumulating in non-bank financial intermediaries (NBFIs).[16] Efforts should also be made to identify and mitigate new risks arising from unconventional financial instruments in the active search for yield.

13) To strengthen support for vulnerable small and medium-sized enterprises facing difficulties, Bank of Korea lowered the financial intermediation support loan interest rates by 0.25 percentage points each in October and November 2024, from 2.00% to 1.50% per annum.

14) For further details, please refer to the Key Issues section of Bank of Korea's November 2024 Korea Economic Outlook, titled "Review of Major Conditions Affecting Korean Exports and Future Prospects.".

15) For further details, please refer to <Box 3> "Review of Internet Bank Funding and Operational Conditions" and <Box 7> "Assessment of Recent Savings Banks' Loss Absorption Capacity and Liquidity Response Ability".

16) For further details, please refer to <Box 5> "Overview and Risk Review of Domestic Non-Bank Financial Intermediaries (NBFI)".

Financial Stability Conditions: Financial system generally stable despite some increases in market volatility

Domestic and external conditions	(+) Strong financial institution resilience and external payment capacity (-) Increased downside risks to the real economy (-) Widened financial and FX market volatility

FSI	Increased slightly Remains at the warning stage	FVI	Shifted to an increase Below long-term average

Vulnerability and Resilience

Credit market	Slower growth in household loans	Continued increase in corporate loan delinquency rates
Asset market	Slower rise in housing sales prices in Seoul metropolitan area	Weak domestic stock prices
Financial institutions	Solid capital adequacy and liquidity	Weakened non-bank asset quality and profitability
External sectors	Strong external payment capacity	Increased exchange rate volatility

Risk Factors

Credit market	Possible increase in financial imbalances on expectations of rate reductions
Asset market	Policy uncertainties at home and abroad, geopolitical risks
Financial institutions	Credit risks in vulnerable sectors
External sectors	Stronger trade protectionism and other external strains

Policy Responses

Bolstering cooperation among policy authorities	• Enhancing monitoring of domestic and external risk developments • Standing ready to conduct timely stabilization measures against unexpected market strains
Monetary and macroprudential policy mix	• Appropriate mix of monetary and macroprudential policies required to prevent a mid- and long-term widening of financial imbalances - (Household) Preemptive and consistent implementation of lending regulations - (Corporate) Maintenance of smooth funding conditions for temporarily struggling companies
Enhancing resilience of financial Institutions	• Continuous efforts to enhance financial institution resilience to prevent a spread of systemic risk • Strengthening of liquidity management and improvement of BCPs for vulnerable financial sectors
Strengthening monitoring	• Close monitoring of borrowers and financial institutions • Identification of risks in non-bank financial intermediaries and unconventional financial instruments