Executive Summary

Financial Stability Situation and Risk Assessment

1. Financial Stability Situation

Korea's financial system has maintained stability overall as the resilience and external payment capacity of financial institutions has remained favorable, despite a slight increase in credit leverage in the second half of this year.[1] In financial markets, volatility expanded and the effects of monetary tightening lessened. Interest rates rose significantly in October, affected by the outlook for prolonged monetary tightening by the U.S. Federal Reserve, but then fell in November driven by growing expectations of an end to monetary tightening by the U.S. Federal Reserve. During the same period, stock prices rebounded after declining. In the financial sector, deposits attracted by high interest rates in the fourth quarter last year were approaching maturity, but they are being smoothly reinvested wihtout any massive withdrawal of funds.

However, the debt servicing burden of borrowers and related credit risks are assessed as having risen due to elevated interest rates, and there were weaker−than−expected incomes and a weaker−than−expected recovery in domestic consumption. As private credit growth has decelerated somewhat slowly in the second half, concerns have arisen over the worsening of financial imbalances. In particular, as household credit growth has not slowed as expected, it could heighten potential vulnerabilities in the financial system and limit household consumption capacity from a medium− to long−term perspective.[2]

2. Financial Stability Situation by Sector

In the credit market, private credit leverage remained at high levels. The corporate credit−to−GDP ratio exceeded levels seen during the Asian Financial Crisis, and the household credit ratio declined at a slower pace than anticipated. Accordingly, if there is an insufficient economic recovery, elevated interest rates may have more negative impacts on repayment capacities of households and businesses. If high levels of household debt continue for a long time, household loans could slow growth by increasing the household debt repayment burden and by constraining consumption. Corporate loans increased greatly after COVID−19, especially in the real estate, construction, and wholesale & retail sectors. If sluggishness in the real estate sector and a delay in the recovery in consumption persist, the debt repayment burden of relevant businesses could increase, and credit risks of relevant loans could rise.

In asset markets, volatility in stock and bond prices expanded, affected by changes in expectations of monetary policy stances in major countries and by geopolitical risks. Housing prices had rebounded rapidly in some regions in the third quarter, but increased at a slower pace overall in the fourth

1) The Financial Stress Index (FSI), which comprehensively shows the short−term stability of the financial system, rose slightly from May (17.8) to 19.3 (caution stage) in November 2023, but is below the level of 24.3 during the short−term financial market instability in the fourth quarter of last year.

2) The Financial Vulnerability Index (FVI), which measures the vulnerability of the financial system from a mid− to long−term perspective, fell from 46.3 in the first quarter of 2023 to 41.5 in the third quarter, approaching the long−term average level (38.1), but the decline seems to be somewhat reduced.

quarter affected by rising lending rates and strengthened household debt management by the government. Looking forward, uncertainties are expected to remain high in the real estate market regarding changes in expectations of market participants, such as housing price forecasts and changes in purchase sentiment.

With regard to financial institutions, asset growth slowed and asset soundness deteriorated. In the case of non-bank financial institutions, in particular, asset growth decelerated as the effects of the implementation of new accounting standards for insurance companies (IFRS17) continued and as lending growth at mutual credit cooperatives and savings banks narrowed. Asset soundness worsened across all financial sectors. Going forward, elevated interest rate levels could increase the debt repayment burden of borrowers with some time lag, and financial institutions might face a higher burden in managing their credit risks if a recovery in domestic demand is delayed. As for those financial institutions that have insufficient loss absorbing capacity, attention should be paid to the possibility of both credit and liquidity risks increasing stemming from capital outflows.

Foreigners' domestic portfolio investment showed high volatility as both stocks and bonds recorded net outflows during parts of the second half of this year, influenced by changes in expectations of monetary policy stances in major countries and by forecasts of business conditions. Capital flow volatility could expand depending on monetary policy operations in major economies and on the development of geopolitical risks.

3. Resilience of Financial System

The financial system's reslience, which means its capacity to withstand domestic and external shocks, has remained favorable, with capital adequacy ratios and liquidity ratios exceeding the regulatory standards. However, the provision coverage ratio declined as substandard-or-below loans increased across all financial sectors.

Korea's external payment capacity has remained solid overall. The decline in net external assets has slowed, and external soundness indicators, such as the ratio of short-term debt to official foreign reserves and the share of short-term debt in total external debt, have improved greatly as short-term external debt has fallen considerably.

Meanwhile, payment and settlement systems operated smoothly without much risk. The settlement amount on major payment and settlement systems, such as BOK-Wire+, has continued to increase, driven mainly by securities settlements by financial institutions and by electronic funds transfers by individuals and companies. Settlement risks have also been managed stably.

4. Major Financial Stability Risk Assessment

As discussed above, Korea's financial system has been stable overall. Amid rising household debt, soundness of household debt has been managed relatively well in terms of the collateral value, credit, and income composition of the borrower with the implementation of LTV and DSR regulations. Financial institutions, especially the banking sector, have continued to build their capacity to respond to a crisis as strengthend global financial regulations were adopted after the Global Financial Crisis. These two factors are assessed as having contributed greatly to maintaining financial system stability under difficult circumstances at home and abroad, such as rising intrest rates. As evaluated externally,[3] Korea has shown better macroeconomic performance than some major countries, with both the government and the Bank of Korea responding actively by coming up with relevant measures more swiftly than in the past regarding market destabilizing factors, such as market instability in the real estate project financing (PF) market and deposit withdrawals at MG Community Credit Cooperatives. These steps are also evaluated as having contributed to stability in the financial market and across the financial system.

However, the possibility of a change in the monetary tightening stance, a weakened recovery in domestic consumption, and uncertainty regarding the outlook for the real estate sector could all act as major risk factors undermining financial stability. This report focuses on examining key issues in consideration of the financial stability situation and the risk factors in Korea.

First, after examining the background to the surge in corporate debt since COVID-19 and evaluating the response capabilities of both enterprises and financial institutions,[4] it was found that corporate credit has expanded quantitatively. However, compared to past crises, such as the Asian Financial Crisis and the Global Financial Crisis, overall financial soundness at companies appears to be robust this time. The delinquency rate on corporate loans is significantly below levels seen during previous crises, indicating that risks from a qualitative perspective appear to be manageable for our financial system. Nevertheless, amid an increased interest burden, the debt servicing ability of some companies that have underperformed recently has notably weakened. This aspect could potentially act as one factor that contributes to the deterioration of asset quality for financial institutions in the future. Additionally, as the short-term borrowing proportion for corporate credit has risen, it is necessary to be mindful that if high-interest rates persist longer than market expectations, there could be an increase in refinancing risks for some companies. Furthermore, the efficiency of resource allocation within the financial system is assessed to have been deteriorated, with an oversupply of loans observed in some sectors, such as the real estate industry.

Meanwhile, an analysis of key risks associated with fund raising and management by deposit-taking institutions during the recent period of rising interest rates has revealed certain aspects.[5] From the perspective of fund raising, there has been an

3) The news magazine The Economist said that Korea has shown the second-best economic performance this year among major countries, and noted that the preemptive interest rate hikes in Korea were a major factor for this performance. The analysis was based on five economic and financial indicators (core CPI, changes in the proportion of consumer products with prices that have risen by more than 2%, growth rate, unemployment rate, and equity prices), from the fourth quarter of 2022 to the third quarter of 2023 ("Which economy did best in 2023?," Finance and Economics Section, The Economist, Dec. 17, 2023).

4) For more information, please refer to the "Review of the Recent Expansion of Corporate Credit and Policy Implications"section in "Analysis of Financial Stability Issues I."

5) For more information, please refer to the "Review of Major Risks of Banks and Non-Bank Depository Institutions" section in "Analysis of Financial Stability Issues II."

expansion of deposits flowing into non-bank deposit-taking institutions, intensifying competition between banks and non-bank deposit-taking institutions in the deposit market, resulting in shorter maturity periods for deposits. This excessive competition in deposit taking not only acts as a factor in diminishing profitability, but also could undermine the stability of fund-raising for financial institutions with relatively low interest rate competitiveness. Regarding the fund management aspect, there has been an expansion of loans sensitive to the real estate market, such as real estate mortgage loans and loans in the construction and real estate sectors, especially among non-bank deposit-taking institutions. Consequently, while high-interest rates are persisting longer than market expectations, should the real estate market undergo a contraction again, which had been gradually recovering, there exists a risk of rapid deterioration in the soundness of non-bank deposit-taking institutions that have a high proportion of real estate-related loans.

Policy Recommendations

First, in aiming to ensure stability in the financial system over the medium- to long-term, efforts should be made to gradually stabilize the ratio of private credit to GDP downward. Initially, regarding household credit, it is necessary to seamlessly implement the "Household Loan Management Measures" that have already been announced, such as the expansion of the Debt Service Ratio (DSR) scope and the introduction of a stress DSR for floating-rate loans. Additionally, it is important to adhere to the principle of extending loans based on debt repayment capacity by reducing household loans not subject to DSR regulations.

In the case of corporate credit, it is necessary to induce a gradual reduction in the proportion of real estate-related exposure, while exercising caution not to trigger a sharp correction in the real estate market. Moreover, to facilitate the soft landing of certain issues related to insolvencies at vulnerable corporations, it is necessary to assess the viability of individual companies and selectively implement debt restructuring and additional financial support measures.

Next, considering the high uncertainty prevailing in the real estate market, it is necessary to continue policy efforts to prevent any related financial instability. Particularly concerning real estate PF, where vulnerabilities are pronounced, it is essential to alleviate concerns about the real estate PF market by supporting the prompt determination of whether to sustain business operations or undergo restructuring through voluntary agreements by major stakeholders. Meanwhile, it is also necessary to guide the orderly resolution of insolvent PF entities in-line with market mechanisms.

Financial institutions should maintain their asset soundness at a healthy level through proactive write-offs and sales of non-performing loans. In particular, they should enhance their loss-absorption capacity by setting aside additional loan loss provisions and raising capital in preparation for the expansion of credit risks on loan assets. Non-bank financial institutions should be encouraged to strengthen their loss-absorption capacity by addressing looser aspects in the provision of coverage compared to banks. Securities firms and credit-specialized financial companies, heavily reliant on market funding, need to strengthen the management of their liquidity situations, such as rollover risks of commercial paper (CP), in response to the possible deterioration in funding conditions.

Finally, policy authorities need to consistently uphold policy coordination among relevant agencies, while closely monitoring the development of risk factors at home and abroad. In particular, non-bank financial institutions may face, not only credit risk, but also liquidity risk in the case of deteriorated funding conditions. Therefore, policy authorities need to enhance the accuracy of their analyses of them and create conditions for timely action by strengthening information-sharing among relevant agencies concerning non-banks.

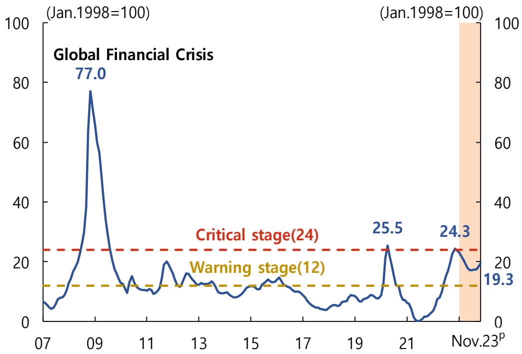
Meanwhile, there is a need to preemptively prepare for the impact on the financial system of potential risk factors emerging from changes in the new financial environment. Specifically, it is expected that the burden on companies to reduce their greenhouse gas emissions will escalate due to the enforcement of domestic greenhouse gas reduction targets in response to climate risk and the full implementation of the European Union's (EU) Border Carbon Adjustment (BCA) by 2026. To tackle this, it is essential to enhance the function of price discovery related to greenhouse gases through the activation of a domestic greenhouse gas emissions trading market. Finally, policy authorities, companies, and financial institutions should cooperate more closely to ensure an orderly transition toward a low-carbon economy.

Key Indicators of Financial Stability

1 Overall Assessment

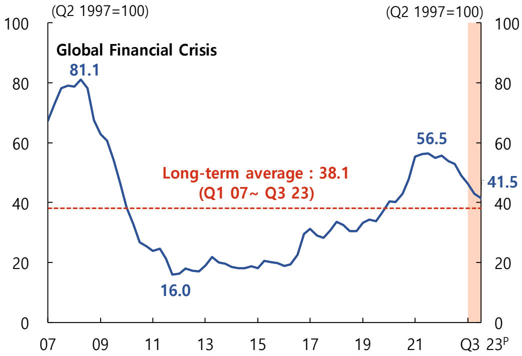
Short-term financial stress (FSI) has risen slightly.
Mid- to long-term vulnerabilities (FVI) have declined, but are above the average.

Financial Stress Index (FSI)



Source: Bank of Korea.

Financial Vulnerability Index (FVI)

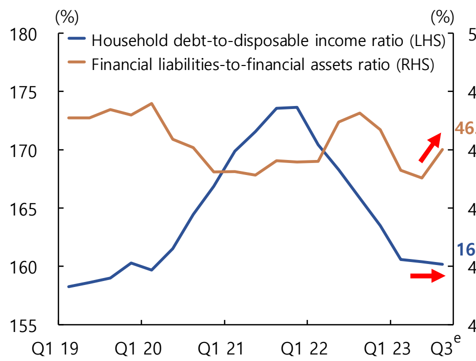


Source: Bank of Korea.

2 Household

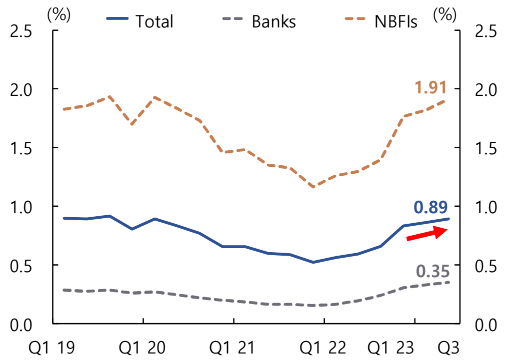
Debt burden among households has increased slightly.
Delinquency rates on household loans have risen.

Debt repayment capacity



Source: Bank of Korea.

Delinquency rates on household loans

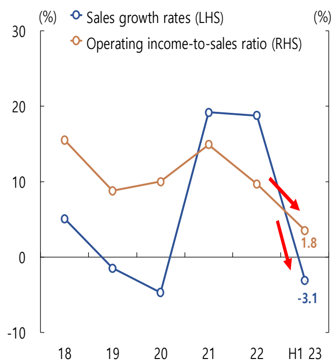


Sources: FInancial institutions' business reports.

3 Corporate

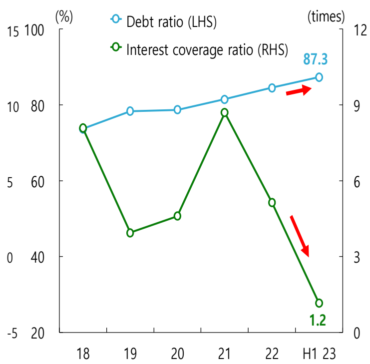
Profitability and interest payment ability at corporations have weakened.
Delinquency rates on corporate loans have risen.

Growth potential & profitability



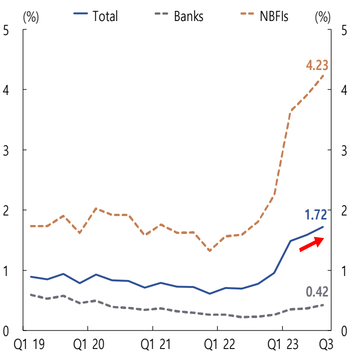
Source: KIS-Value.

Debt ratio & interest coverage ratio



Source: KIS-Value.

Delinquency rates on coporate loans

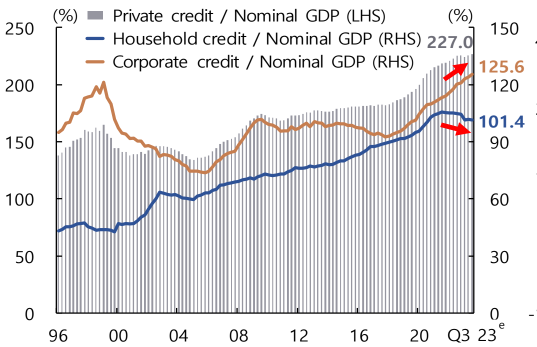


Sources: FInancial institution business reports.

4 Credit Leverage

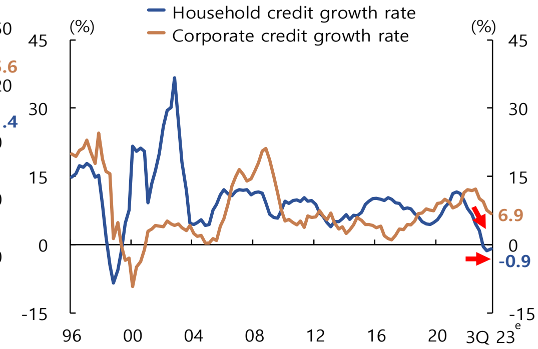
Private credit leverage has risen.
The decline in household credit has been reduced.
The increase in corporate credit has been reduced.

Private credit–to–nominal GDP ratios



Source: Bank of Korea.

Credit growth by sector

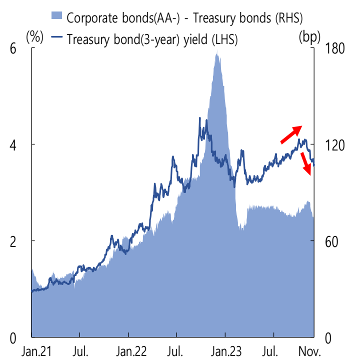


Source: Bank of Korea.

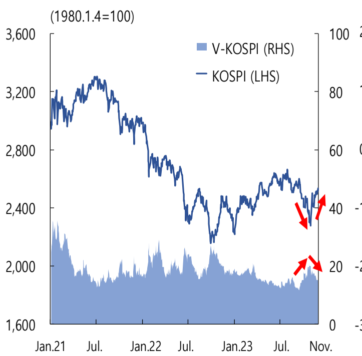
5 Asset Market

Korea Treasury bond (KTB) yields fell after rising.
Stock prices rebounded after falling.
The increase in housing prices has slowed.

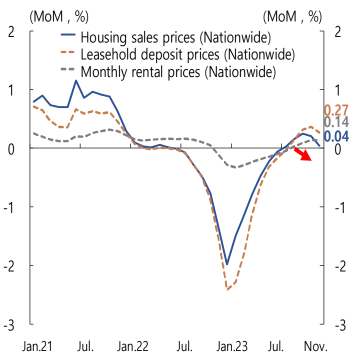
Treasury bond yield & corporate bond credit spreads



Stock prices & stock price volatility



Rates of increase in housing prices

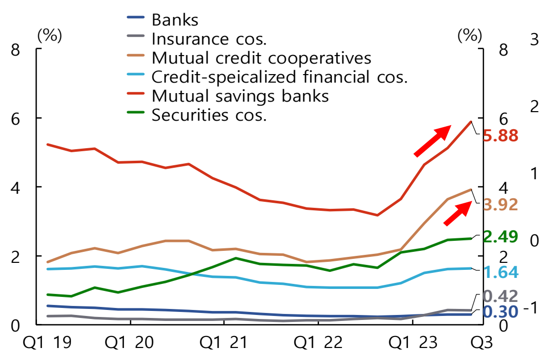


Source: Korea Financial Investment Association. Source: KOSCOM. Source: Korea Real Estate Board.

6 Soundness of Financial Institutions

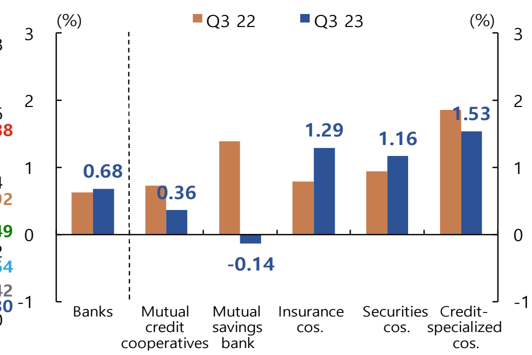
Asset quality at financial institutions has deteriorated.
Profitability varies by financial sector.

Substandard–or–below loan ratio



Sources: FInancial institution business reports.

Return on assets (ROA)

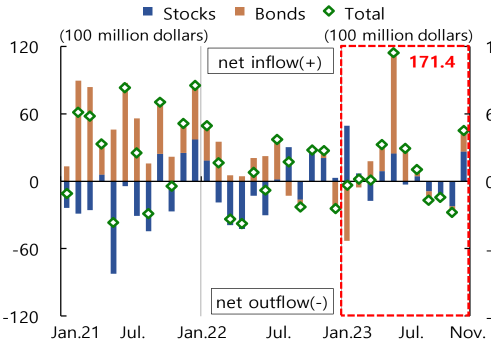


Sources: FInancial institution business reports.

7 Capital Flows

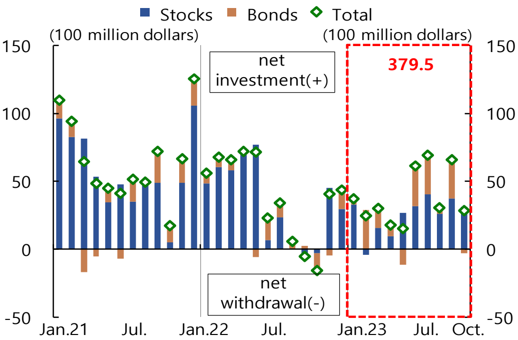
Foreigners' domestic portfolio investment recorded a net inflow.
The increase in residents' overseas portfolio investment expanded slightly.

Changes in foreigners' domestic portfolio investment



Source: Bank of Korea.

Changes in residents' overseas portfolio investment

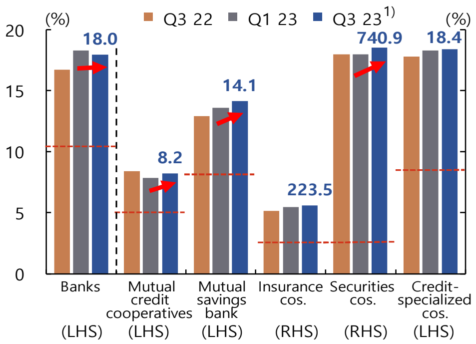


Source: Bank of Korea.

8 Resilience of Financial System

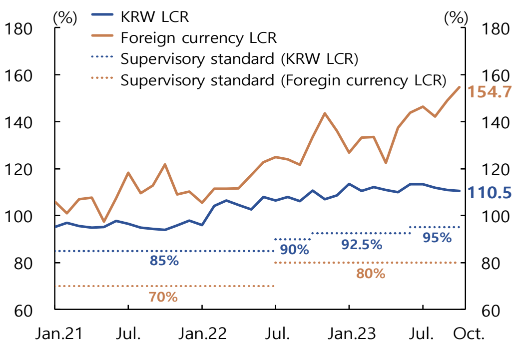
The resilience of banks and NBFIs have remained strong.

Financial institution capital adequacy ratios



Notes: 1) As of Q2 2023 for insurance companies.
Sources: FInancial institution business reports.

Commercial banks liquidity coverage ratio (LCR)

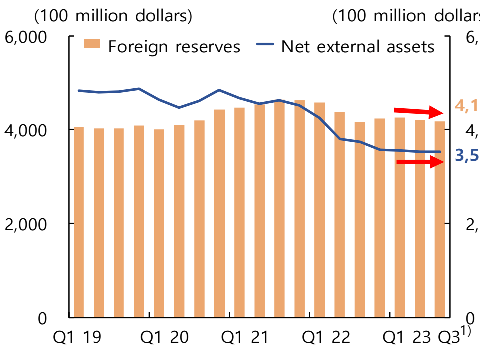


Sources: FInancial institution business reports.

9 External Payment Capacity & Payment and Settlement Systems

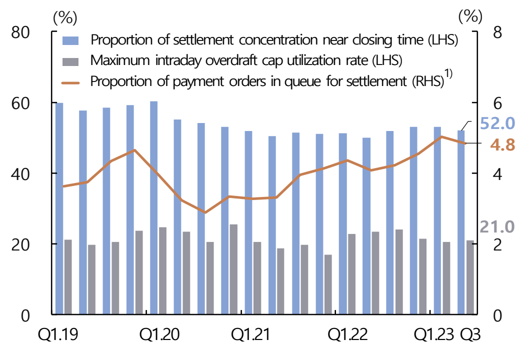
External payment capacity has remained strong.
Settlement risk has been managed appropriately.

Official foreign reserves[1] & net external assets



Notes: 1) As of November 2023 for foreign reserves.
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.