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FOR INFORMATION

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March 18, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of Korea—Financial System Stability Assessment—Statement by the Executive Director**

Board Action: Executive Directors' **information**

Additional Information: The attached statement from the Alternate Executive Director for the Republic of Korea, is being issued on the Republic of Korea—Financial System Stability Assessment (SM/20/65, 3/10/20) which is being considered on a lapse of time basis.

Statement by Mr. Heo, Mr. Shin, and Mr. Yoo on Republic of Korea—Financial System Stability Assessment

On behalf of our Korean authorities, we thank staff for their comprehensive Financial System Stability Assessment (FSSA) report, and for the very constructive policy and technical discussions that preceded it throughout the past year. We think that the FSAP analysis can help the authorities stand ready for unexpected global events and improve the resilience of the financial system to shocks, including from the global spread of the COVID-19 virus which is impacting both the real and financial sectors.

1. The Coronavirus (COVID-19) Epidemic and Policy Actions in Korea[1]

The coronavirus spread quickly from February 19 in concentrated areas in the southeast region of the Korean peninsula. To limit contagion, the Korean government is making all-out, pre-emptive efforts to respond to the outbreak through early detection, extensive screening, full-scale epidemiological analysis, and early treatment of confirmed cases, while disclosing information internationally in a very transparent manner. Up to 15,000 tests are being conducted every day using advanced diagnostic capabilities. The test is free to anyone—including undocumented migrants—who has symptoms or a clinician referral and is easy to access through ten-minute, drive-through clinics. Thanks to these innovative and aggressive measures, the daily number of new confirmed cases, which peaked at slightly over 900 on February 29, had decreased to 93 on March 18. As of March 18, more than 295,000 people had been tested with 8,413 cases confirmed and 84 deaths, giving a fatality rate of 1.0 percent.

The outbreak is inevitably generating negative global economic impact, and Korea is no exception. To mitigate the economic fallout from the virus, the authorities have taken a sweeping range of measures including credit support to SMEs and small merchants, broad tax deferral to affected businesses, support for local economies hit hardest, and targeted transfers to affected households, small merchants and SMEs. These measures cost a total of 32 trillion won or 1.7 percent of GDP. The Bank of Korea (BOK) lowered its base rate by 50 basis points to 0.75 percent, an all-time low, and cut the interest rate on the Bank Intermediate Lending Support Facility to 0.25 percent. In addition, BOK broadened eligible collateral for open market operations as part of measures to provide ample liquidity to financial markets. The authorities stand ready to provide additional fiscal and monetary measures, if necessary.

2. Korea FSSA

Overall Assessment

[1] We are sharing Korea's current situation and policy responses to the coronavirus outbreak for your information and because the pandemic has affected the modality of the IMF Board discussion on Korea's FSAP.

The authorities welcome the FSSA's positive assessment overall of the soundness and resilience of Korea's financial system. The financial sector, overall, remains resilient even under a very adverse scenario with the risk of systemic contagion within the financial system contained. They appreciate the Fund's recognition of good progress since the previous FSAP, especially on putting in place regulatory and supervisory regimes that are broadly in line with international standards. The authorities support many of the recommendations made in this FSAP.

Risks and Vulnerabilities

Stress test results. The Korean economy features an advanced manufacturing sector that is closely integrated into global value chains, high household leverage against real estate, active capital markets, and the use of non-reserve currency. The adverse scenario in the stress test combines a number of related, key risks: a severe recession, significant capital outflows, strong exchange rate depreciation, and sharp falls in house and equity prices, all under the assumption of escalating global trade tensions and a world-wide sell-off in financial markets. The FSAP team assesses that the scenario is severe enough to encompass the impact on economic activity implied by COVID-19. Solvency stress tests show that both the banking and insurance sectors withstand a series of adverse macro financial shocks. Separately, liquidity stress tests on domestic and foreign currencies also reveal overall resilience thanks to the introduction of stronger regulatory measures. In addition, the team conducted stress tests for the household and non-financial corporate sectors, with the former performed jointly with BOK. Under the adverse scenario, the results show a rise in solvency risk for households and in corporate debt-at-risk, but with contained and manageable impacts. BOK and the Financial Supervisory Service (FSS) also conducted stress test exercises for bank solvency under the same adverse scenario using their own models, in consultation with the FSAP team, and obtained similar results.

Future challenges. Going forward, the FSSA rightly points to key challenges—a lower growth and interest rate environment, fintech development, and adverse demographic shifts. While these challenges are global phenomena confronting all countries, demographic shifts are particularly salient in Korea. Our authorities acknowledge that all of these challenges could have significant implications for the financial system as well as the overall economy and have been making a great effort to mitigate and prepare for them.[2] In this respect, we thank the FSAP team for examining several effects of these key challenges on financial stability and for making forward-looking recommendations. This will be helpful to our authorities and potentially to other countries facing similar challenges. Our authorities are committed to further enhancing stress testing practices to further identify and estimate systemic vulnerabilities.

[2] For example, the Korean government has launched a series of taskforces on population policy to prepare action plans to deal with future demographic challenges.

Household debt. The authorities share the FSSA's view that high household indebtedness is the main vulnerability for the financial system. At the same time, the authorities are of the view that household debt risks are manageably contained. To mitigate these risks, the authorities have actively developed various macroprudential measures. Limits on loan-to-value (LTV) and repayments-to-income ratios for mortgages are set quite conservatively by international standards—as low as 40 percent in speculation-prone metropolitan areas. Loan underwriting standards have been tightened. Prudent measures that limit overall borrowing to high-debt-service-ratio households have been introduced. As such, household debt growth has steadily slowed since 2017 and has recently dropped at around 4 percent year-on-year. The quality of household loans has been improving. The share of loans by borrowers with high-credit ratings (grades 1-3) has steadily increased from 60 percent in 2014 to 75 percent in 2019, which partly contributes to lower credit losses incurred by banks in the stress testing exercises. Household stress tests suggest that solvency risk would increase following an adverse shock, but the magnitude is not substantial. The ratio of debt (relative to GDP) held by households at solvency risk (defined as those who are liquidity constrained and have a debt-to-asset (DTA) ratio above 100 percent) has stayed at around 4 percent for the past five years, even though household leverage has risen overall. In order to keep assessment balanced, some terminologies need to be revisited. For example, without clear explanation, ambiguous expressions, such as "*immediate* solvency risk" would leave room for interpretation. Moreover, definition of "solvency risk" needs to be assessed from the both income and asset aspects. Technical limitation of a data set, too, should be pointed out in order to capture full picture. Some data sets would overstate vulnerabilities of households, but it is not clearly stated in the report. Our authorities remain vigilant and stand ready to take action against potential risks in the household sector, including increased indebtedness of older-aged cohorts.

Fintech development. As with most innovations, fintech provides both risks and opportunities. Box 1 in the report nicely presents an analysis of illustrative risk that fintech could pose to individual banks. This analysis implies that fintech and open banking have a negative impact on bank capital due to increased competition for banks. But from a broader and system-wide perspective, financial innovation—in combination with big data and artificial intelligence—can reduce inefficiency from information asymmetry, create new services, enhance competition, and facilitate resource reallocation from less- to more-efficient uses, thereby improving consumer welfare and supporting growth. This dynamic, positive, and systemic effect can offset a decline in the profits of incumbent banks. Hence, innovation in fintech may not necessarily give rise to capital depletion in aggregate. On the potential risk of an 'electronic deposit run,' this is rather hypothetical under the current system of low daily caps on the amount that can be moved. Our authorities continue to update the regulatory and supervisory framework to balance facilitating financial innovations against monitoring and assessing implied financial stability risks such as security and operational risks, liquidity risks, and concentration risk due to network effects.

Macroprudential Policy Framework

Our institutional framework for financial stability features a multi-agency system where key macroprudential responsibilities are shared. Through close coordination and cooperation among the agencies, the financial system has been operating in a healthy manner. Going forward, however, we see merit in further strengthening the framework by stipulating macroprudential oversight as its primary objective of the Macroeconomic and Finance Meeting (MEFM), an existing inter-agency forum for financial stability matters.

Financial Supervision

We welcome the FSSA's assessment that microprudential oversight is broadly effective. We have implemented regulatory and supervisory regimes generally in line with international standards and, as a result, financial institutions are well capitalized and have improved risk management. Building on the success so far, our supervisory authorities seek to place greater emphasis on enhancing the risk management capabilities of financial firms. In insurance, the authorities are committed to intensifying risk-based supervision and ensuring a proportionate implementation of the Korea Insurance Capital Standard, a new fully-risk-based solvency regime. The authorities also note a gap in the supervision of financial conglomerates and have already started to prepare new legislation to enhance their oversight.

Climate Change

Korea has become a large source of Environmental, Social and Governance (ESG) bonds since its first issuance in 2013. The BOK joined the Network for Greening the Financial System last year. As part of the *2020 Partnering for Green Growth and the Global Goals 2030 (P4G) Summit*, scheduled to be held in Seoul, June 29-30, the authorities are preparing a special session on *Mega-Transition into Green Finance and Economy: Immediate Action for Climate Change from Risk Management to Green Economy*. This will discuss the implications of climate change on financial systems, policies and supervision. This special event will serve to increase the levels of preparedness and public awareness to climate change risks in Korea and around the globe.