**LAPSE OF TIME**

SM/20/65
Correction 3

March 24, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of Korea—Financial System Stability Assessment**

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| Board Action: | The attached corrections to SM/20/65 (3/10/20) have been provided by the staff: |
| **Evident Ambiguity** | **Pages 1 and 26** |
| Questions: | Mr. Das, MCM (ext. 36330) |

INTERNATIONAL MONETARY FUND

# REPUBLIC OF KOREA

## FINANCIAL SYSTEM STABILITY ASSESSMENT

March 10, 2020

## KEY ISSUES

The FSSA was prepared by a staff team of the IMF for the Executive Board's consideration on Friday, March 27. The staff report reflects discussions with the Korean authorities in September and December 2019 and is based on the information available as of end June 2019. It focuses on Korea's near and medium-term financial stability challenges and policy priorities and was prepared before COVID-19 became a global pandemic and resulted in unprecedented strains in global trade, commodity and financial markets. It, therefore, does not reflect the implications of these developments and related policy priorities. Staff is closely monitoring the situation and will continue to work on assessing its impact and the related policy response in Korea and globally.

**Context:** Operating within a trade dependent open economy, Korea's financial system is among the most developed and internationally connected in Asia. The state keeps a tight control and operates a rules-based oversight system. On the back of robust past economic performance, new regulations, and continued state support, most parts of the banking system appear prudentially strong. Prospects for banks and insurers are, however, dimming due to growth related uncertainties, low interest rates, rising competition from fintech and nonbanks, and adverse demographics induced shifts in financial behavior of households.

**Findings**: The overall financial system appears resilient for the present, but with growing vulnerabilities. Stress tests suggest that banks and insurers, in aggregate, can weather severe macro financial shocks, although some banks would make use of capital conservation buffers. Growth related uncertainties, and elevated household debt remain key vulnerabilities to financial stability. The leasehold deposit market (Jeonse) —a unique aspect of Korean housing finance—presents a potential vulnerability for the real estate market. A strong rules-based financial supervision is in place, but financial conglomerates are not under adequate oversight, and stronger focus is needed to monitor transmission channels between securities markets and banks, and across asset classes.

**Policies**: While banks are adequately capitalized for now, a sectoral countercyclical buffer for their household exposures is desirable. A more robust identification of systemic risk conditions across entities and market activities is needed via enhanced stress testing practices as well as risk and impact assessments of the emerging fintech-

**20. Around 15 percent of total household debt is currently registered 'at-risk' and around 11 percent at ~~immediate~~ solvency risk.** Around 4 percent of household debt is held by households who are both at solvency risk (defined as having a debt-to-asset ratio above 100) and liquidity constrained.[6] Higher household leverage ratios—debt-to-income and loan-to-value ratios, collectively known as the double trigger of mortgage default—are associated with a higher probability that a household's debt is at-risk. Household stress tests, done jointly with the BoK, suggest that the amount of debt held with liquidity constrained insolvent households will rise following an adverse income (house price) shock from around 4 to 5.3 (6.6) percent of GDP. The impact of shocks on household balance sheets grow with age, with retiree households most at risk from a hike in interest rates.

## B. Non-Financial Corporate Sector Vulnerabilities

**21. Korean non-financial corporate debt (about 100 percent of GDP) is higher than the G20 average and one quarter appears "at-risk", which mostly resides with SMEs (Figure 11).** The debt of larger firms is concentrated in market-based instruments, while SMEs (about 35 percent of total corporate debt) are largely funded by bank credit. Despite strong global trade growth since 2013 there has been an increase in the number of firms reporting (i) a negative ROA, (ii) negative revenue growth, (iii) insufficient liquidity and (iv) an interest coverage ratio below 1. Corporates are most vulnerable to a slowdown in global growth coupled with higher funding costs, while a weaker exchange rate would have a limited impact on corporate balance sheets, given low FX debt and natural hedges.[7] Balance sheet stress tests show a rise in corporate debt-at-risk (where earnings before interest and taxes are less than their interest expenses) under the adverse scenario, although total credit losses would likely remain contained reflecting large cash buffers.[8]

**22. The statutory framework for corporate debt resolution (including for SMEs) could be a mitigating factor in an adverse scenario.** The efficiency of in-court procedures has improved with the establishment of the Seoul Bankruptcy Court in 2017. Key challenges to effective reorganization are delays in filing which negatively impact the possibility of successful business rescue; and the difficulties in securing post-commencement financing for companies undergoing rehabilitation. The framework could benefit from establishing an insolvency practitioner profession, including to ensure that the highly supervised judge-led institutional framework does not become gridlocked with a high volume of cases in a crisis.

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[6] Debt is considered "at-risk" if held by liquidity constrained households, defined as being unable to meet consumption, debt servicing payments, and monthly rent from disposable income and highly liquid savings.

[7] Since the GFC, FX onshore corporate debt has declined to about 4 percent of bank loans and 11 percent of market-based debt.

[8] Based on data for listed corporates. There are some concerns about the reliability of SME balance sheet data and profit and loss statements.