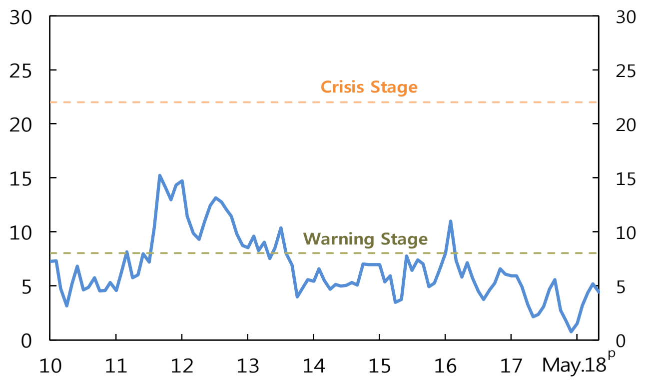
Unofficial translation

[Executive Summary]

The Korean financial system has remained stable, as capacities for absorption of domestic and external shocks have improved amid a slowdown in the pace of household debt growth recently, although the potential risks due to the household debt buildup still exist. The Financial Stability Index (FSI), showing overall financial system conditions, has risen somewhat in 2018, due to expanded market price volatility, but during May was also running below the warning stage level (8.0), at 4.4.

Financial stability index (FSI)[1)]



Note: 1) A composite index (0~100) calculated by standardizing 20 monthly real and financial sector indicators related to financial stability. The warning and crisis stage thresholds are set at 8 and 22 respectively, using the 'noise-to-signal ratio' method.
Source: The Bank of Korea

A look at the financial stability conditions in the different sectors shows, first of all, that in the case of the credit markets the pace of growth in household credit has slowed but is still sustaining a high level compared to normal years. By type of loan, the growth in home mortgage lending has slowed, but unsecured loans and loans for funding leasehold deposits have expanded greatly. In this situation of accumulated household debt it is necessary to bear in mind the possibility that, if lending interest rates rise rapidly debt repayment burdens can rise as well, especially for the vulnerable groups. Corporate credit has meanwhile been increasing even despite a drop in lending to large enterprises, in consequence of expanded lending to small and medium-sized enterprises. Corporate financial soundness has improved, owing for example to the improved business conditions and to companies' efforts for business management rationalization. With regard to SMEs, however, real estate finance exposures continue to increase, driven by loans to sole proprietors in the real estate leasing business for example, and there is a need for close examination related to this.

In the asset markets, long-term market interest rates have risen under the influence primarily of the movements of long-term interest rates in major countries including the US. Stock prices had shown a trend of increase entering 2018, but then fell sharply on the growing likelihood of an accelerated pace of interest rate hikes by the US Federal Reserve, before showing a modest recovery due for example to the easing of risks related to North Korea. In the housing market, the pace of increase in purchase prices, in the Seoul metropolitan area in particular, has gradually slowed, while leasehold deposit prices have shown an overall trend of decline.

With regard to financial institutions, asset soundness and profitability at commercial banks have remained at satisfactory levels. The trends of improvement in asset soundness at non-bank financial institutions have continued, but profitability has differed in line with management conditions in the various individual sectors. Going forward there is a need to bear in mind the possibility of declines in asset soundness at financial institutions, due for example to the worsening of some vulnerable borrowers' debt repayment capacities in the phase of rising interest rates.

The financial system's resilience, i.e. its capability of withstanding domestic and external shocks, has remained favorable. Capital adequacy ratios, indicating loss absorption capacities, have greatly exceeded the regulatory standards at both banks and non-bank financial institutions, while provision coverage ratios have also generally risen. With regard to the nation's external payment capacity, net external assets and the official foreign reserves have increased, and the short-term external debt ratio has maintained a low level.

The Korean financial system is showing stability overall, as mentioned above, but the continuing high pace of growth in household debt is working as a factor heightening its potential risks. It appears particularly necessary to focus even more on preemptive risk management, to prepare for domestic and external uncertainties related for example to upward pressures on market interest rates following the monetary policy normalizations by central banks in major countries and to the spread of protectionism. In connection with household debt, managing the rate of its growth at a stable level is important from the macroprudential perspective. With regard to corporations, it is necessary to strengthen credit management related to vulnerable firms and to continue the efforts for restructuring. Together with these steps, additional efforts are needed to boost asset soundness and capital adequacy at financial institutions.

[Financial Stability Situation]

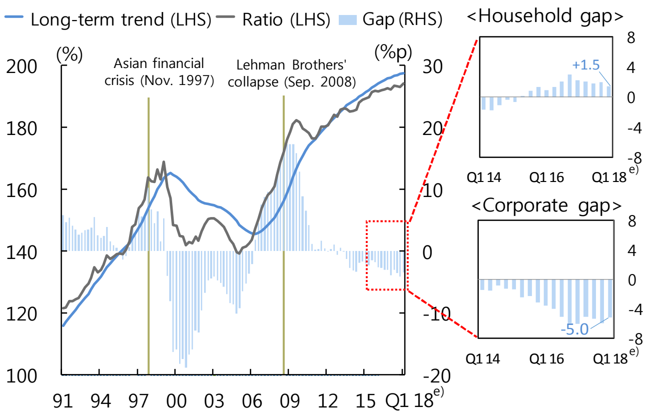
Ⅰ. Credit Markets

1 The private credit-to-nominal GDP ratio has continued its upward movement in 2018 also, but the ratio's gap, showing the degree of deviation from its long-term trend, has remained negative (-).

The private credit-to-nominal GDP ratio rose by 0.9% point compared to the end of last year to stand at 194.0% (estimated) at the end of the first quarter of 2018. The ratio's negative (-) gap narrowed slightly from that at year-end 2017 (-4.1% points) to stand at -3.5% points.

Looking at the private credit situations in the various sectors, entering this year the pace of increase in the household credit-to-GDP ratio has slowed somewhat, while in contrast the corporate credit-to-GDP ratio rose slightly for the first time in three quarters since the second quarter of 2017. In line with this the positive (+) extent of the household credit-to-nominal GDP gap narrowed to +1.5% points at the end of the first quarter of 2018, while the negative (-) extent of the corporate credit-to-nominal GDP gap decreased to −5.0% points.

Private credit[1]−to−nominal GDP[2] ratio and gap[3]



Notes: 1) Estimated figures for Q1 2018
2) Sum of seasonally adjusted nominal GDPs in quarters concerned and in immediately preceding three quarters
3) Difference between private credit−to−nominal GDP ratio and its long−term trend

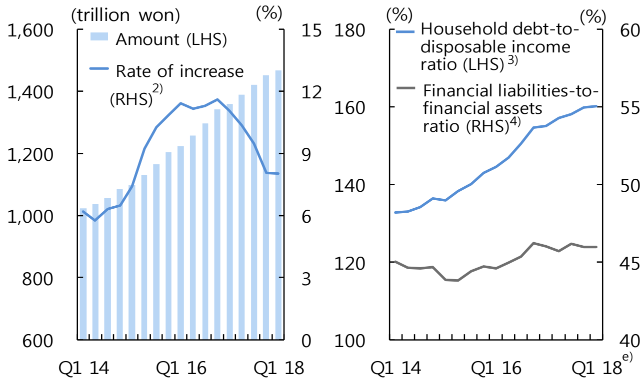
Source: The Bank of Korea

2 The pace of household credit growth has slowed, but its slowdown has eased somewhat recently. Household debt (household credit statistics basis) increased by 8.0% year-on-year to 1,468.0 trillion won at the end of the first quarter of 2018. Its pace of growth has been slowing since the first quarter of last year, but is still higher than in normal years (quarterly average 7.1% between 2010 and 2014). By type of loan, the growth in home mortgage loans has slowed, but unsecured loans and loans for funding leasehold deposits have expanded greatly.

The household debt-to-disposable income ratio was 160.1% at the end of the first quarter in 2018, having increased by 5.0% points year-on-year. Households' financial liabilities-to-assets ratio (flow of funds statistics basis) meanwhile maintained a level similar to the normal years' average (45.7% between 2010 and 2014) at 46.0% (estimated), as households' financial assets also grew steadily along with their financial liabilities.

In a situation of accumulated household debt the possibility should be borne in mind that difficulties in debt repayment can increase if lending interest rates rise rapidly, especially for the vulnerable groups.

Household debt[1)]



Notes: 1) Household credit statistics basis
2) Year−on−year
3) Disposable income for Q1 2018 estimated using household disposable income−to−gross national income ratio (average of immediately preceding three years)
4) Based on flow of funds statistics; estimated figure for Q1 2018

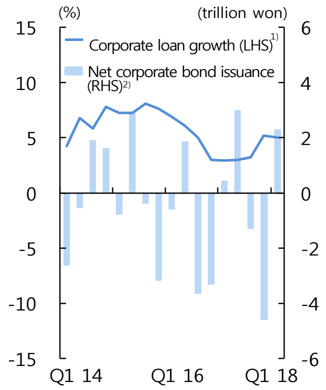
Source: The Bank of Korea

3 Corporate credit has shown a trend of expansion even despite reduced lending to large enterprises, as lending to small and medium-sized enterprises has increased. Corporate lending by deposit-taking banks totaled 804.1 trillion won at the end of the first quarter of 2018, up by 5.0% year-on-year. Loans to large firms decreased (-5.0%), as the sluggishness in their loan demand persisted, but lending to SMEs expanded by 7.8%, driven by loans to sole proprietors in the real estate leasing industry for example.

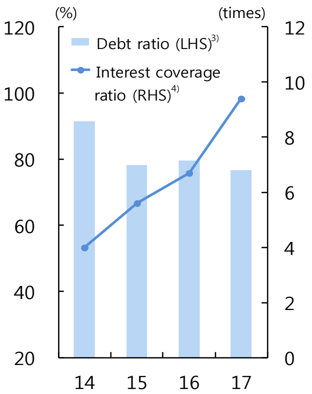
Corporate financial soundness has improved, thanks to the better business conditions and to companies' efforts aimed at management rationalization. The corporate debt ratio (debt / equity capital) was 76.7% at the end of 2017, to remain at a low level, and the corporate interest coverage ratio (operating income / interest expenses) was considerably higher, owing for example to increases in sales and to improvements in profitability as a result of companies' efforts to cut costs. However, while the interest coverage ratio of large enterprises had risen to a considerable extent (2016 6.9 → 2017 9.7), that at SMEs had fallen slightly (3.8 → 3.5) and a picture of differentiation based on company size had appeared.

Meanwhile, the possibility should be kept in mind that, if domestic or external conditions including the increase in external trade pressures owing to the strengthening of protectionism worsen, then management difficulties can become heavier for some companies with vulnerabilities in terms of their financial soundness.

Corporate credit



Corporate financial soundness and interest payment capacities



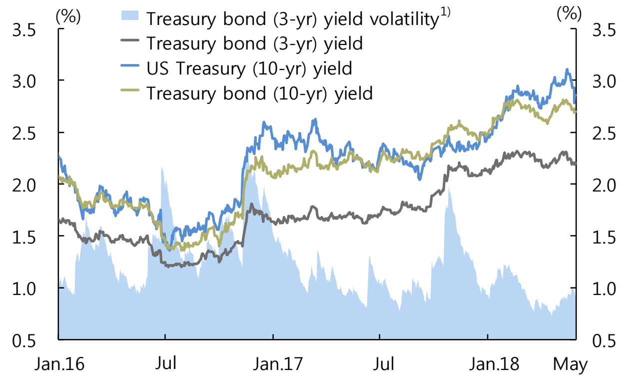
Notes: 1) Deposit−taking bank basis; year−on−year
2) During the quarter
3) Debt / Equity; end−period basis
4) Operating income / Interest expenses

Sources: The Bank of Korea, KIS−Value, banks' business reports

Ⅱ. Asset Markets

1 Long-term market interest rates rose until the latter part of January this year, affected primarily by the movements of long-term interest rates in major countries including the US, before then fluctuating in line with domestic and external factors.

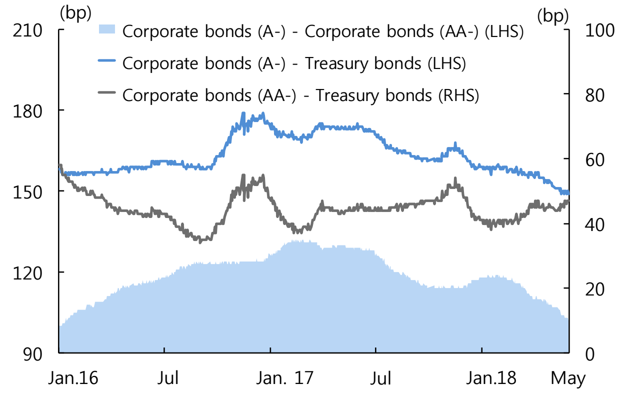
Korean and US Treasury bond yields



Note: 1) Daily volatility calculated using exponential weighted moving average (EWMA) method
Sources: Korea Financial Investment Association, Bloomberg

The corporate bond markets have shown stable pictures generally, with credit spreads especially on sub-prime (A-) bonds narrowing and issuance and circulation volumes increasing. The situation of credit differentiation has also shown some easing, owing for example to steady investment demand for subprime bonds.

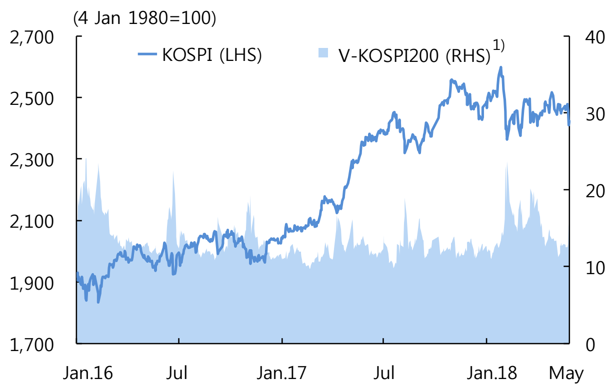
Corporate bond credit spreads,[1)] and spread across credit ratings



Note: 1) 3-year maturity basis
Source: Korea Financial Investment Association

2 Stock prices, after having increased at the beginning of 2018, then fell sharply as the likelihood grew of an acceleration in interest rate hikes by the US Federal Reserve, but showed a modest recovery from March in line for example with the easing of North Korea-related risks. Stock price volatility soared temporarily on the greatly expanded anxieties in the stock market during February, before then showing a general decline.

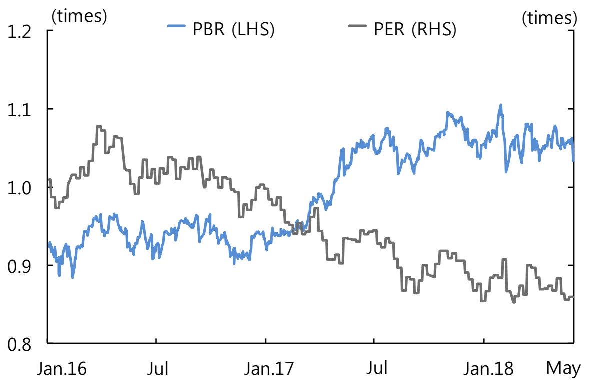
Stock price and stock price volatility indices



Note: 1) Volatility index calculated based on prices for options on KOSPI200 index
Source: KOSCOM

The price-to-book ratio (PBR) and the price-to-earnings ratio (PER), showing the levels of a stock's price relative to its liquidation value and profitability, were 1.04 and 8.60 respectively at the end of May this year, having thus maintained levels similar to those (1.05 and 8.54) at the end of 2017.

PBR[1] and PER[2]

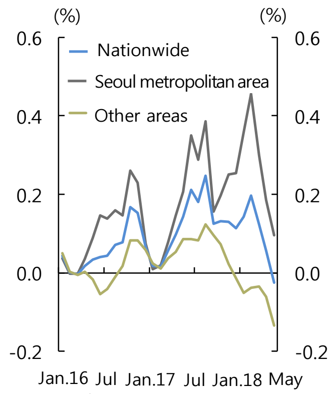


Notes: 1) KOSPI basis; Price / Book value per share
2) MSCI basis; Price / Earnings per share
Sources: Bloomberg, Thomson Reuters

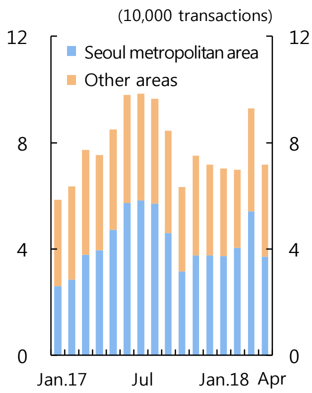
3 The upward trend in housing purchase prices of the beginning of this year showed a picture of gradually slowing. Prices rose sharply in the Seoul metropolitan area during January and February, before slowing greatly from March, while in the other parts of the country they continued to fall. Leasehold deposit and monthly rental prices showed trends of decline owing to increases in supply.

The volume of housing purchases expanded greatly year-on-year from January through March, centering around the Seoul metropolitan area, ahead of the implementation of capital gains tax imposition on multiple housing owners (from April 2018). From April the transaction volume on the other hand reversed to a decline, as most of the sales by multiple housing owners were settled and a wait-and-see attitude toward housing purchases also appeared.

Rates of increase in housing sales prices[1]



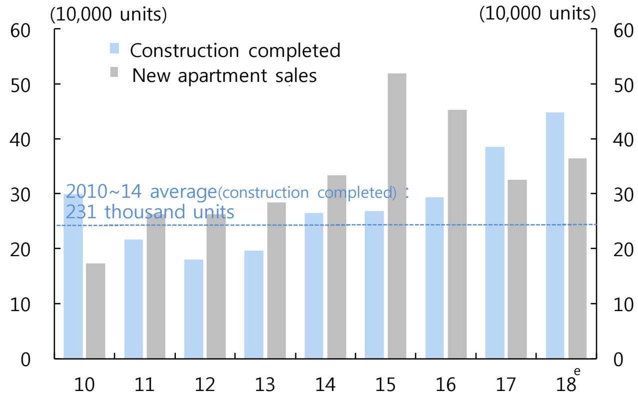
Housing sales transaction volumes



Note: 1) Compared to previous months
Source: Korea Appraisal Board

During 2018 the quantity of apartments whose constructions are completed will be 448 thousand units, well in excess of the normal year's average (231 thousand units from 2010 to 2014), and the volume of new apartments planned for construction has been counted as likely to be slightly higher than that last year.

Quantities of apartments completed and new apartment sales[1)]



Note: 1) Based on sums of planned monthly quantities as of June 8, 2018

Source: Real Estate 114

III. Financial Institutions

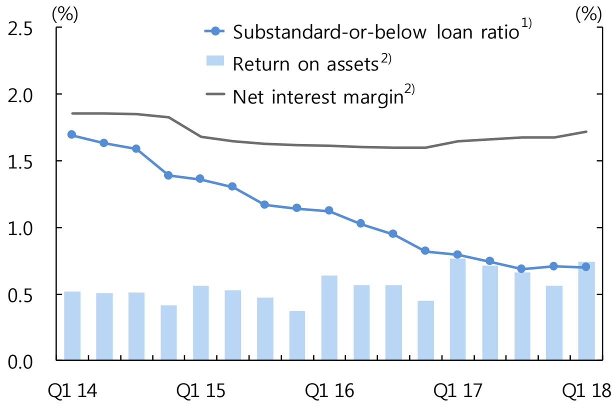
1 At commercial banks, the pace of increase in their total assets has accelerated in 2018 also. At the end of the first quarter commercial banks' total assets amounted to 1,561 trillion won, up by 6.7% year-on-year as they thus recorded their highest rate of increase since the third quarter of 2015 (8.5%).

In terms of asset soundness, the substandard-or-below loan ratio sustained its very low level at 0.70% at the end of the first quarter of this year, thanks to factors such as commercial banks' strengthening of risk management and corporations' efforts to boost their financial soundness.

Profitability has shown a favorable picture, just as it did last year. Return on assets (ROA) rose to 0.56% during 2017, higher by 0.11% point than in the year before, and during the first quarter of this year it was 0.74% – a level similar to that (0.77%) in the same period last year. By sector, interest earnings have increased due to widening net interest margins, and foreign exchange-related earnings have fallen while loan loss expenses have declined.

There is a need to be mindful of the possibility of bank asset soundness deteriorating in the future, as borrowers' debt repayment burdens grow due to factors such as rising interest rates.

Commercial bank asset soundness and profitability



Notes: 1) End-period basis
2) Accumulated quarterly incomes annualized

Sources: Commercial banks´ business reports

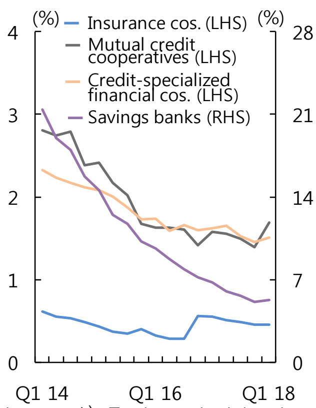
2 The favorable management soundness at non-bank financial institutions has also been sustained.

The volume of non-bank financial institutions' assets increased by 7.9% year-on-year to total 2,478 trillion won at the end of the first quarter of 2018, and is continuing its solid growth. In line with this the proportion in total financial sector (bank and non-bank financial institution) assets (5,107 trillion won) accounted for by non-bank financial institutions rose by 1.1% points year-on-year to 48.5% at the first quarter-end.

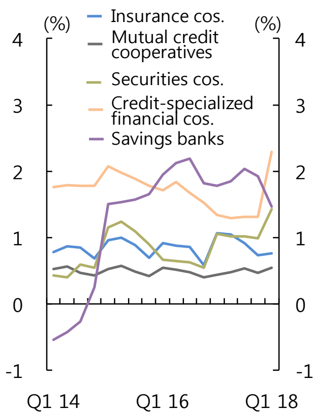
Asset soundness has continued to improve, with delinquency rates and substandard-or-below loan ratios generally falling. Profitability has shown differing pictures in accord with management conditions in the various individual sectors. In the cases of securities companies and mutual credit cooperatives profitability has improved, thanks to expansions in commission revenues and to increased interest earnings for example, but at savings banks and insurance companies it has declined somewhat, on upward adjustments in provision coverage accumulation standards, slowdowns in insurance earnings, etc.

In the case meanwhile of credit card companies, there is a need for attention to the possibility of declining profitability and worsening soundness in line with changes in their business environment.

NBFI substandard-or-below loan ratios,[1)] by sector



NBFI returns on assets (ROAs)[2)]

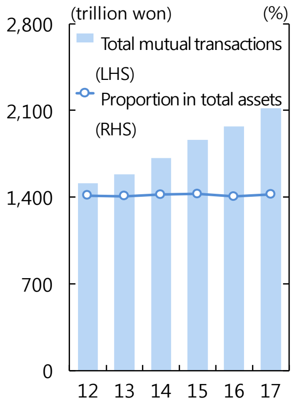


Notes: 1) End-period basis
2) Accumulated quarterly incomes annualized
Sources: Financial institutions´ business reports

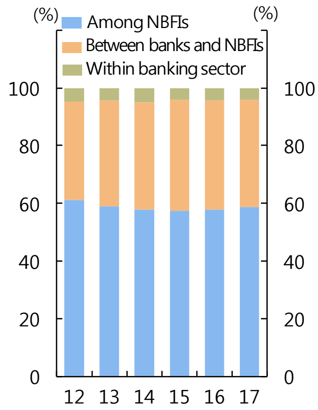
3 The amount of mutual transactions among financial institutions has continually increased. Total mutual transactions in the financial sector as a whole jumped by 7.6% from the end of the previous year to 2,120 trillion won as of year-end 2017. The proportion in the total mutual transaction volume accounted for by transactions among non-bank financial institutions recorded 58.6%, higher by 0.9% point than at the end of 2016, and the interconnectedness in the non-bank financial institution sector is strengthening. The shares accounted for by mutual transactions between banks and non-bank financial institutions, and within the banking sector, were meanwhile 37.2% and 4.2% respectively, and had fallen slightly since the previous year-end. Looking at the various types of financial institutions involved, the amounts of mutual transactions of banks, trusts, securities companies and investment funds are relatively large, while among these institutions domestic banks are continuing their central role.

Meanwhile, the proportion of the mutual transactions in the financial sector relative to total sector assets was 30.3%, a level similar to that at the previous year-end (30.1%). In addition, the default contagion and concentration risk indicators, showing the cross-sectional risks stemming from interconnections, showed pictures generally similar to those at the end of last year as well.

Amounts of financial institutions' mutual transactions[1)]



Proportions of mutual transactions across sectors[1)2)]



Notes: 1) End-period basis (flow of funds statistics)
2) Proportions in the total amount of mutual transactions
Source: The Bank of Korea

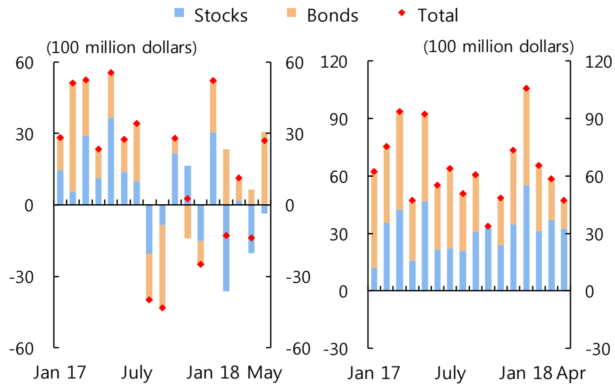
Ⅳ. Capital Flows

Portfolio investment funds of foreigners have continued to flow in on net during 2018, even despite factors such as the monetary policy normalizations by central banks in major countries and the financial unrest in some emerging market countries. Funds for investment in stocks recorded a net outflow of 2.8 billion dollars during the January to May 2018 period, while bond funds showed a net inflow of 9.2 billion dollars.

The solid trend of growth in the Korean economy and the easing of geopolitical risks related to North Korea can for the time being have positive effects on the inflows of funds for portfolio investment by foreigners. However, as shown by the financial unrest in some EMEs, the possibility must be borne in mind of international financial market uncertainties expanding and capital flow volatility increasing in the course of the monetary policy normalizations in advanced countries.

Residents sustained a net overseas portfolio investment position of 27.6 billion dollars during the January to April 2018 period, against a background of favorable foreign currency liquidity in line with the global economic recovery and the nation's current account surplus.

Changes in foreigners' portfolio investment funds[1)]　　Changes in residents' overseas portfolio investment[2)]



Notes: 1) A '+' means net inflow, and a '–' net outflow.
2) A '+' means net investment, and a '–' net withdrawal.
Source: The Bank of Korea

[Financial System Resilience]

Ⅰ. Financial Institutions

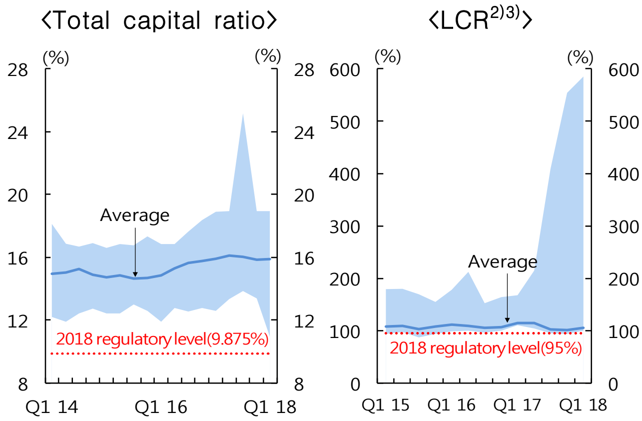
1 Commercial bank resilience has sustained its favorable conditions in 2018 as well.

The provision coverage ratio, indicating commercial bank capacities for absorbing expected losses, was 13.4% points higher year-on-year at 105.6% at the end of the first quarter this year, thanks for example to banks' efforts for risk management and to the improvements in corporate business conditions. The Basel III total capital ratio, which shows capacities for absorption of unexpected losses, was also favorable at 15.89% as of the end of the first quarter.

The liquidity coverage ratio (LCR), showing banks' capacities for responding to sudden net outflows of funds in a short period of time, fell by 8.8% points year-on-year to 105.8% at the end of the first quarter of 2018, affected by the strengthening of the method of its calculation (implemented in July 2017) for example. All banks nevertheless exceeded the regulatory standard (95%).

Going forward as well it will be necessary to prepare for factors such as increased uncertainties at home and abroad, and to make efforts to ensure that the recent favorable profitability can lead to expansions in capital.

Resilience of commercial banks[1)]



Notes: 1) Shaded areas indicate distributions of individual banks
2) High-quality liquid assets / Total net cash outflows over next 30 calendar days (end-period basis until 2016, and based on average balance of last month of the quarter from 2017)
3) In calculating the LCR, the conditions for classification of wholesale deposits as commercial deposits, on which relatively low runoff rates are applied, were strengthened from March 2017.

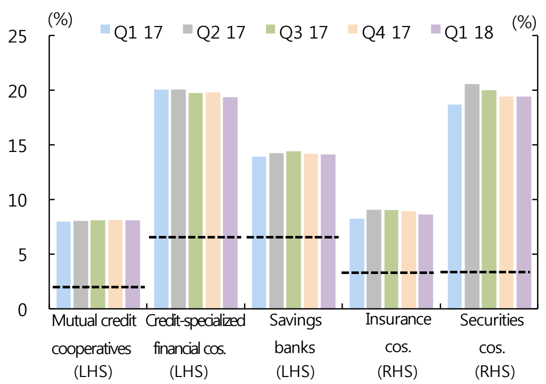
Sources: Commercial banks´ business reports

2 Resilience at non-bank financial institutions has also been maintained at satisfactory levels in most sectors, with their capital adequacy ratios exceeding the supervisory standards.

Life insurance companies' risk-based capital (RBC) ratio rose by 11.5% points, from 246.7% at the end of the first quarter of 2017 to 258.2% at the end of the first quarter in 2018, thanks to their efforts to expand capital in preparation for introduction of the mark-to-market system for evaluation of insurance liabilities (IFRS 17). Credit-specialized financial companies' adjusted capital ratio also greatly exceeded the supervisory standard (7~8%), at 19.4% as of the end of the first quarter of 2018, while most capital adequacy indicators in other sectors were also satisfying the supervisory standards. Among securities companies, the net capital ratio was 21.6% points above that at the same time last year at 582.9% as of the first quarter-end in 2018, owing to the effects for example of paid-in capital increases by large securities companies for purposes of receiving permissions to engage in the short-term funding business.

In the case meanwhile of insurance companies, given their high proportions of investment in long-term assets exposed to large interest rate volatility risks, it will be necessary to prepare for future rises in interest rates.

NBFI capital adequacy ratios[1)2)]



Notes: 1) Insurance companies´ risk-based capital ratio (supervisory standard of 100%), mutual credit cooperatives´ net capital ratio (2%; for MG community credit cooperatives 4%, and for NongHyup 5%), securities companies´ net capital ratio (100%), credit-specialized financial companies´ adjusted-capital ratio (7%; for credit card companies 8%), savings banks´ BIS capital ratio (7%; for banks with total assets of 1 trillion won or more 8%)

2) Dotted lines show the supervisory standards

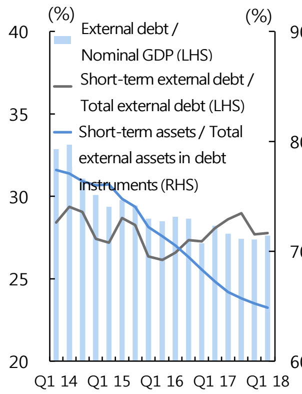
Sources: Financial institutions´ business reports

II. External Payment Capacity

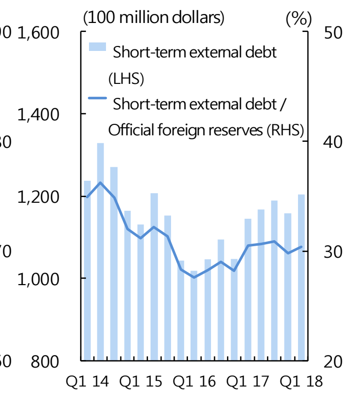
Korea's satisfactory external payment capacity has persisted during 2018 as well.

Net external assets (external assets - external liabilities) have continued their trend of increase, while the external debt-to-nominal GDP ratio fell slightly compared to the same period last year (28.2%) to register 27.6% at the end of the first quarter of 2018. The nation's official foreign exchange reserves recorded their highest ever level at the end of May this year, at 399.0 billion dollars, while the ratio of short-term external debt relative to the foreign exchange reserves was also continuing at a low level similar to that (30.5%) at the same time last year, at 30.4% at the first quarter-end.

Proportions of short-term external debt and assets in debt instruments[1)]



Short-term external debt-to-official foreign reserves ratio[1)]



Note: 1) End-quarter basis

Source: The Bank of Korea

III. Financial Market Infrastructures

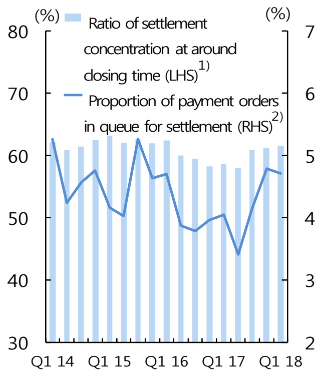
BOK-Wire+ and the other major payment and settlement systems have been operated stably, with settlement risks maintaining satisfactory levels amid a continued trend of increase in the settlement volume. Given the expectations going forward of steady increases in securities settlement by financial institutions, related for example to inter-institutional RPs, and in electronic funds transfers by individuals and corporations through Internet and mobile banking, efforts to secure payment and settlement system safety will also need to be strengthened.

The maximum intraday overdraft cap exhaustion rate and the proportion of payment orders in queue for settlement, indicative of the level of secured settlement liquidity of participants in BOK-Wire+, the nation's large-value payment system, were 21.9% and 4.7% respectively during the first quarter of 2018, and showed generally stable movements. However, the proportion in total settlements through BOK-Wire+ of that carried out at around the closing time (16:00~17:30) was slightly higher than that recorded last year (59.9%) at 61.5% in the first quarter.

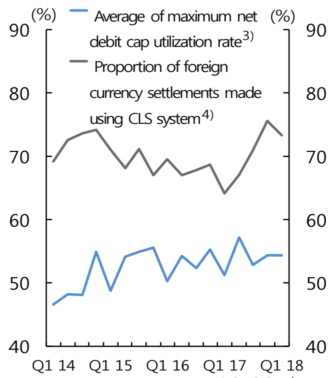
The net debit cap utilization rates, showing settlement risks related to the retail payment systems operated by Korea Financial Telecommunications & Clearings Institute, were also managed at satisfactory levels continuing on from last year.

Meanwhile, among all foreign exchange settlements through the foreign exchange settlement systems, the proportion handled by the CLS payment-versus-payment system, which reduces settlement risk effectively through the settlement of foreign exchange transactions without any time lag, was 73.3% during the first quarter of 2018, and thus maintaining its high level of last year.

Large-value payment system



Retail payment and foreign exchange settlement systems



Notes: 1) Amount of settlement processed after 16:00 / Total settlement amount
2) Amount of payment orders in queue for settlement / Total settlement amount (excluding payment orders in queue for liquidity savings)
3) Simple average of daily maximum net debit cap utilization rates (Unsettled net debits / Net debit caps) of participants during quarter
4) Proportions of total CLS eligible FX transactions of those settled through the CLS (continuous linked settlement) system

Source: The Bank of Korea