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Press Release

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BASEL III QUANTITATIVE IMPACT STUDY AND ITS IMPLICATIONS

The Basel Committee on Banking Supervision ("the Committee") published the results of its comprehensive quantitative impact study (QIS) on December 16, 2010 to ascertain the impact of the Basel III rules on banks' capital adequacy, leverage and liquidity ratios. A total of 263 banks from 23 of the 27 Committee member jurisdictions participated in the study.

In Korea, 8 banks submitted data for the comprehensive QIS including 5 Group 1 banks (Woori, Shinhan, Hana, KB and IBK) and 3 Group 2 banks (Nonghyup, Daegu and Busan).

Capital ratios as of year-end 2009

Group 1 banks' average common equity Tier 1 (CET1) capital ratios under the new regime would have sharply fallen from an average gross CET1 capital ratio of 11.1% to 5.7%.

This decline is mainly attributable to the new definition of capital deductions and filters not previously applied at the common equity level of Tier 1 capital. For the Group 1 banks, the reduction in CET1 capital is driven primarily by deductions of goodwill, etc.

For larger banks (Group 1 banks), the change in net CET1 capital (with deductions) compared to gross CET1 capital (without deductions) amounts to -41.3%. The reduction in C ET1 capital of Group 1 banks from Korea by deductions amounts to 3.2%.

In the meantime, CET 1 capital ratio of domestic banks would remain around 10.3% under the Basel III Framework, exceeding a CET1 target level of 7% (including the capital conservation buffer).

Average capital ratios by banking group, in percent

		CET1		Tier 1		Total		Change in CET 1 by deductions
		Gross	Net	Current	New	Current	New	
Group 1	Average*	11.1	5.7	10.5	6.3	14.0	8.4	-41.3
	Korean banks	**11.3**	**10.3**	**11.1**	**10.4**	**14.7**	**13.5**	**-3.2**
Group 2	Average*	10.7	7.8	9.8	8.1	12.8	10.3	-24.7
	Korean banks	**10.4**	**9.7**	**10.7**	**10.0**	**15.3**	**13.4**	**-1.8**

*Average of banks from 23 countries

Relative to a 7% CET1 level, the capital shortfall for Group 1 banks in the QIS sample is estimated to be €577 billion (KRW880 trillion) under the Basel III requirements (including the capital conservation buffer). As a point of reference, this is 2.8 times the sum of profits after tax prior to distributions across the same sample of Group 1 banks in 2009 which was €209 billion.

Meanwhile, Korean banks would bear almost no burden of capital ratio management in the short term if the new standards are implemented.

However, as banks from industrialized countries are expected to raise funds in the future, domestic banks may have a burden in the mid-to-long term for the rollover of maturing subordinated debts.

If banks are required to hold contingent capital that converts into common equity or amortizes on the probability of default, the cost of funding is also expected to rise.

Leverage ratio

The average leverage ratio of domestic larger banks is 4.6%, far exceeding the 3% minimum leverage ratio.

The average leverage ratio of Group 1 banks from all 23 countries is 2.8% and approximately 42% of the Group 1 banks in the sample would fall short of a 3% requirement.

This is because they have increased leverage mostly by being engaged in higher credit-rated assets such as securities, derivatives and securitized lending.

However, as banks are to be required to disclose their leverage ratios starting from 2015, there will be more restrictions on increasing leverage through derivatives, etc.

Leverage ratio, in percent

		Leverage ratio	Banks falling short of the requirement as a percentage of total banks
Group 1	Average*	2.8	42
	Korean banks	**4.6**	-
Group 2	Average*	3.8	20
	Korean banks	**5.1**	-

*Average of banks from 23 countries

Liquidity ratio

The new liquidity standards result in an average liquidity coverage ratio (LCR) of 83% for Group 1 banks and the average net stable funding ratio(NSFR) is 93%, falling short of the 100% minimum requirement.

For the banks in the sample, QIS results show a shortfall of €1.7 trillion (KRW2,600 trillion) in liquid assets to meet the required LCR as of end-2009 and a shortfall of €2.9 trillion (KRW4,430 trillion) for the NSFR at the end of 2009.

Korean banks in Group 1 in the sample also did not meet the minimum liquidity requirement with their LCR standing at 76% and the NSFR at 93%.

Liquidity ratio, in percent

		LCR	NSFR
Group 1	Average*	83	93
	Korean banks	**76**	**93**
Group 2	Average*	98	103
	Korean banks**	**75**	**99***

* Average of banks from 23 countries
**Average of Daegu and Busan banks excluding Nonghyup

Accordingly, domestic banks are expected to strengthen their efforts to attract stable retail deposits and change their portfolio toward focusing on liquid assets such as sovereign debt.

They are expected to attract more salary-transfer accounts by providing preferential interest rates in an effort to increase stable deposits with the low run-off rate of 5%.

In bond markets, the demand for sovereign or corporate bonds rated AA- and above is expected to increase and bank debentures are expected to have longer maturity of two to three years rather than one year considering liquidity ratio requirements.

In the meantime, credit and liquidity facilities in the outflow categories, where domestic banks have a relatively high presence, are expected to decrease in the future.

In a comprehensive way, stronger capital and liquidity requirements under the Basel III may hurt the profitability of the banking industry, raise lending rates and decrease lending volume.

In particular, the regulatory cost is expected to rise sharply for some banks in advanced countries of which capital, leverage and liquidity ratios fall short of the requirement.

However, the new regime is expected to enhance safety of the banking industry, lowering funding costs in the mid-to-long term.

In addition, with enough transition period before the full implementation, banks are expected to be able to accommodate short-term concerns over strengthened rules if they increase their holdings of capital and liquid assets steadily.

In domestic banking industry, relatively high capital and leverage ratios are not likely to cause any setback in banks' credit extension. Although liquidity ratios currently do not meet the minimum requirement, the transition period (observation period) is enough.

Also, the Basel Committee will continue to conduct an impact study during the transition period and allow change of the new rules, if necessary.

If banks prepares for the new regime by launching new deposit products that will help increase liquidity ratios, reschedule maturities of bank debentures and adjust undrawn credit line which is not necessary, they will not have a big trouble in meeting the new standards.

In addition, the stronger requirements are expected to serve as an opportunity for the banking industry to pursue sound management strategies.

The regulator will make necessary adjustments to the system and oversee the banking industry to protect its intermediary functions during the transition to full implementation.

Appendix

Components of outflows and inflows and composition of liquid assets of banks

Relative to Group 1 banks, funding from unsecured retail and small business customers and credit and liquidity facilities accounts for a relatively large portion of LCR outflows (liabilities) in Korean banks. Foreign banks are more leveraged from asset securitization.

For LCR inflows, retail and small business customers account for a relatively large portion in Korean banks while secured lending, including RP purchase, accounts for a relatively large portion in foreign banks.

LCR outflows and inflows as a percentage of gross outflows, in percent

Category	Group 1 banks		Group 2 banks	
	Total	Korea	Total	Korea
Outflows to…	**100.0**	**100.0**	**100.0**	**100.0**
Unsecured retail and small business customers	9.7	12.8	18.1	16.6
Unsecured non-financial corporates	15.9	17.9	21.4	17.6
Unsecured financial institutions	27.6	27.6	26.3	20.4
Unsecured sovereign, central bank, public sector entities (PSEs) and other counterparties	9.7	8.1	6.6	19.5
Secured funding	2.4	0.6	1.2	1.7
Collateral, securitizations and own debt	24.9	4.7	10.9	4.9
Credit and liquidity facilities	2.3	21.4	2.7	9.8
Other cash outflows including derivative payables	7.3	6.9	12.8	9.5
Inflows from…	**22.2**	**27.5**	**40.5**	**16.0**
Retail and small business customers	2.5	8.0	8.4	5.7
Non-financial corporates	3.2	3.1	5.9	1.7
Financial institutions	7.8	11.7	16.9	7.2
Other entities	0.8	0.4	1.1	0.5
Secured lending	7.5	0.1	6.1	0.2
Asset-backed commercial paper (ABCP), conduits, structured	1.3	4.3	1.6	0.8

investment vehicles (SIVs) and own account, performing security cash flow				
Other cash inflows including derivative receivables	6.1	-	15.9	-

In composition of liquid assets, cash, central bank reserves and public sector entities account for a large portion for Korea banks while sovereigns account for the majority for foreign banks.

Composition of holdings of liquid assets of banks, in percent

Category	Total	**Korea**	Category	Total	**Korea**
Cash	5	10	Domestic sovereign debt issued in foreign currency	3	0
Central bank reserves	19	24	Corporate bonds, AA- and above	2	10
Sovereigns	**45**	**21**	Covered bonds, AA- and above,	2	0
Central bank debt	6	7	Other sovereigns	1	0
Government-related institutions	12	10	**Public sector entities**	**6**	**18**

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