Financial Services Commission

# Press Release

December 5, 2019

# MEASURES TO IMPROVE MANAGEMENT OF RISK EXPOSURE IN PROJECT FINANCE

The government introduced its plans to improve the management of risk exposure in real estate project finance on December 5.

## BACKGROUND

Project financing in real estate is a financing mechanism based on the business value of the project and the expected cash flows of the project in the future. Due to the recent financial deepening and continuing low yields, project financing has increased significantly. Project financing provides an efficient way to finance real estate or infrastructure development projects.

However, due to heavy reliance on the expected value of the project, risk exposure is highly dependent on market conditions. Without proper management of risks, or in the case of a distortion of profits or risks, it may pose a threat to financial stability.

Risk exposure in project financing has continued to increase especially in non-bank sectors since 2013. The prevalence of high-risk project financing loans, such as bridge loans, has dropped whereas the level of exposure by securities companies and specialized credit finance companies increased. Debt guarantees in project financing also increased as the burden of credit exposure shifted from construction companies to financial institutions.

## RECENT TRENDS

At the end of June 2019, the total amount of debt guarantees in project financing stood at KRW28.1 trillion, out of which KRW26.2 trillion issued by securities companies. The outstanding loan balance in project financing stood at KRW71.8 trillion, rising on average 11.6 percent a year from KRW39.3 trillion at the end of 2013. By the end of June 2019, both the default rate and the sub-standard asset ratio continued to decline since 2013 from 13.0 percent to 1.9 percent and 16.9 percent to 3.0 percent, respectively, due to an increased volume in project financing loans.

## KEY MEASURES

### I. IMPROVING THE SOUNDNESS OF DEBT GUARANTEES IN PROJECT FINANCING

► Establishing an upper ceiling on debt guarantees

Under the current system, securities companies face no upper limits on issuing debt guarantees. The new measure places an upper ceiling to 100 percent of equity capital and restricts securities companies from issuing debt guarantees over that limit.

For specialized credit finance companies, the current regulation only limits their issuance of project finance loans to 30 percent of their credit assets, which include bonds, lease assets, credit card assets and credit-based provisional payments. The new measure will place an upper ceiling on the issuance of combined amount of project finance loans and debt guarantees to 30 percent of their credit assets.

► Strengthening capital requirements & standards for bad debt reserves

Debt guarantees are generally categorized as off-balance sheet financing although they may be counted as on-the-balance based on market conditions. Despite regulations on debt guarantees, such as capital requirements, asset quality classification and bad debt reserves, there still exists loopholes in regulations.

For securities companies, the current regulation applies low capital requirements for debt guarantees, currently at 12 percent, for assessing credit risks. The new measure raises the capital requirements for debt guarantees to 18 percent.

Specialized credit finance companies will be required to set up bad debt reserves for project finance debt guarantees at an equivalent rate as those for project finance loans, while applying a 100 percent credit conversion factor.

► Managing liquidity risks

Securities companies are required to conduct stress test of their own and submit liquidity management plans to the regulatory authority. For securities companies whose adjusted liquidity ratio falls below 100 percent, the Financial Supervisory Service will strengthen its risk management and supervision.

For specialized credit finance companies, a new set of supervisory standards on liquidity risk management will be established during the second half of 2020, which will include provisions for debt guarantees in project financing.

## II. Strengthening the Soundness in Project Finance Loans

► Eliminating inducements that contribute to an increase in project finance loans

i) Under the current system, the issued notes of payment or assets in management are excluded when calculating a leverage ratio. However, the new measure will require that real estate investment assets in excess of 10 percent of the financing amount of the issued notes to be included when calculating a leverage ratio.
ii) Real estate-related loans will be excluded from additional limits to credit offering for companies (from 100% to 200% of equity capital).
iii) The special exemption for real estate loans will be abolished and real estate

loans will be counted toward the amount of net working capital.

► Improving the current bad debt reserve requirements

Currently, there exist discrepancies in bad debt reserve requirements for different sectors. For securities companies, specialized credit finance companies and savings banks, the current system allows lower reserve ratios when payment is guaranteed by qualified investment companies or that the related assets are apartments. However, the new measure eliminates this provision.

(Unit: %)

| | Bad debt reserve requirements for project finance loans | | | | |
|---|---|---|---|---|---|
| | Regular | Caution | Fixed | Doubtful loans | Estimated loss |
| Banks & insurance companies | 0.9 | 7 | 20 | 50 | 100 |
| Securities companies, specialized credit finance companies & savings banks | 0.5*/2~3 | 7**/10 | 30 | 75 | 100 |
| Mutual finance companies | 1 | 10 | 20 | 55 | 100 |

* When payment is guaranteed by qualified investment companies
** Apartment assets

## III. Establishing a Risk Assessment & Monitoring System in Project Finance

► Establishing a monitoring system on project financing risk management

The new measure is aimed at encouraging financial companies to strengthen risk management by establishing a periodic monitoring system – (i) select financial companies subject to closer monitoring in Q1 every year, (ii) conduct supervision of risk exposure management trends in Q2 every year, and (iii) share results with relevant financial authorities and institutions and apply remedies in H2 every year.

► Performing stress test to prepare for risks

The government plans to set up a system to perform stress tests – (i) develop methodology and framework for performing stress tests in Q1 2020, (ii) select a risk scenario every year, and (iii) perform a stress test based on the risk scenario, and implement follow-up measures.

► Strengthening disclosure rules in project financing

From 2020, financial companies will be encouraged to disclose the following information in their business reports, such as the size and proportion of risk exposure in project financing, proportions of project financing business sites by location, business purpose and credit worthiness of construction companies, as well as the result of their own internal risk exposure assessment.

► Establishing a comprehensive system to manage risk exposure in project financing

Due to the lack of a comprehensive risk management system, detecting systemic risks has been difficult, even though a routine monitoring system for both project finance loans and debt guarantees has been up and running.

The government plans to establish a comprehensive risk management system on real estate financing in 2020, which will also introduce provisions for a regular monitoring of risk exposure in project financing. The comprehensive system will include real estate financing in household, corporate and financial investment sectors. By selecting major indicators in each sector and developing methodologies for risk analysis, a database of risk exposure will be set up by different sectors.

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