Financial Services Commission

Press Release

March 16, 2023

PRUDENTIAL REGULATIONS ON BANKS TO BE REVAMPED FOR IMPROVING LOSS ABSORBING CAPACITY

The FSC and the FSS discussed the plans for bolstering capital adequacy and loan loss reserve requirements in the banking sector to improve banks' loss absorbing capacity, as part of the agenda at the 3rd working group meeting of the taskforce on improving the management and operating practices of banks and banking system held on March 15.

BACKGROUND

The banking sector, whose soundness remained in good shape even in the pandemic situation, has faced with growing uncertainties since interest rates sharply increased and the won-dollar exchange rates surged in 2022.

(CAPITAL ADEQUACY) As of the end of September 2022, the CET1 (common equity tier 1) capital ratio stood at 12.26 percent, which is well above a minimum CET1 capital ratio requirement (7.0 to 8.0 percent), but is lowered than 12.99 percent at the end of 2021 due to the impact of losses on bond portfolio, etc. When compared to major economies,[1] the capital adequacy remains relatively low, and banks' recent moves to expand dividends are likely to lead to a further decline in their capital ratios in the future.

(ASSET SOUNDNESS) The delinquency rate on bank loans, which had fallen during the pandemic, is gradually edging up[2] primarily led by the household sector, due to recent increases in loan interest rates, etc.

<Major Soundness Indicators of Domestic Banks (%, %p)>

Category	End-2018	End-2019	End-2020	End-2021 (a)	End-Dec 2022 (b)	Change (b-a)
CET1 capital ratio	12.31	11.46	12.45	12.99	12.26 (end-Sep)	-0.73
Delinquency rate	0.40	0.36	0.28	0.21	0.25	+0.04
Household credit loan	0.43	0.41	0.34	0.29	0.46	+0.17

In order to ensure sufficient loss absorbing capacity of the banking sector in preparation for future uncertainties, authorities plan to improve prudential regulations on banks (capital adequacy and loan loss reserve requirements) for preemptive risk management.

[1] CET1 capital ratio (end-Sep. 2022): 14.74% (EU), 15.65% (UK), 12.37% (U.S.), 12.26% (Korea)
[2] Actual ratio of overdue debt is expected to be larger when considering the possibility of illusion in indices obfuscated by the government's COVID-19 financial support measures.

Measures to Revamp Prudential Regulations in Banking Sector

I. Improvement of Capital Adequacy Requirement

a) Imposition of Countercyclical Capital Buffer (CCyB)

(As Is) CCyB was introduced in 2016 as part of the Basel III capital regulations but the level of CCyB remains zero percent until now. As the amount of credit rapidly increased from the second half of 2019, there were signals in which banks were supposed to accumulate CCyB. However, due to rising uncertainties amid the spread of COVID-19, the level of CCyB was maintained at zero percent.

(Implementation Direction) To be prepared for potential deterioration of credit which had been rapidly expanded during the COVID-19 pandemic, authorities will examine a measure to impose a duty on banks to set aside additional capital in the second or third quarter of this year. Additionally, considering cases of other countries which operate CCyB[3], authorities will pursue a measure which requires banks to maintain capital buffer on a regular basis even in the absence of signals for the need to set aside CCyB, in preparation for unexpected external shocks (spread of an infectious disease, geopolitical risk, etc.)

(Required Action) A decision by the FSC should be made to require additional capital accumulation by banks.

b) Introduction of Stress Capital Buffer

(As Is) Currently, financial authorities require banks to regularly conduct stress tests to assess their loss absorbing capacity such as capital adequacy ratio, etc. However, even when test results are insufficient, there is no legal ground for authorities to enforce direct supervisory measures such as imposing a duty to accumulate additional capital, etc. on individual banks.

(Implementation Direction) Considering cases from major countries, such as the U.S. and the EU,[4] authorities will seek to introduce stress capital buffers that will require banks to set aside additional capital depending on each bank's stress test result. At the same time, authorities plan to overhaul the verification and ex-post management of the entire test process to help improve the credibility of banks' stress tests.

(Required Action) A revision to the supervisory regulation on banking business is required.

[3] (a) UK introduced CCyB rate of 1% in 2016, which will be increased to 2% from Jul. 2023; (b) Australia revamped its CCyB system that allows relevant authority to adjust its CCyB rate between 0% and 3.5% and decided to set its CCyB rate at 1% from 2023; and (c) Sweden plans to apply CCyB rate of 2% from Jun. 2023.

[4] (a) In the U.S., the Federal Reserve conducts stress tests on large banks, and based on the results, banks are required to set aside additional capital at different rates. In 2022, Fed required more than 30 banks to set aside additional capital at between minimum 2.5% to maximum 9.0%. (b) In EU, the ECB requires large banks to set aside additional capital at different rates based on the risk assessment results (which include stress test results). In 2022, the ECB required more than 100 banks to set aside maximum 4% of additional capital.

II. REQUIREMENT OF ALLOWANCE FOR BAD DEBT

a) Introduce an authority to request banks to set aside special reserve for credit loss

(AS IS) Currently, the amount of allowance for bad debt is calculated based on the minimum ratio required under the regulations on supervision of banking business.[5] That makes it difficult for banks to preemptively reflect a possibility of cyclical fluctuations and expand their loss absorbing capacity accordingly.

(TO BE IMPROVED) Based on the result of assessment conducted by the FSS on the level of adequacy of banks' allowance and reserve for bad debt, the FSC will be able to request banks to set aside additional loan loss reserve if the amount of their allowance and reserve for bad debt are deemed insufficient against the estimated future loss.

b) Establish a system to inspect banks' models for forecasting estimated loss

(AS IS) The current management and supervision system on banks' models to forecast estimated loss, which are set up by each bank to accumulate loan loss reserves, is inadequate.

(TO BE IMPROVED) A regulatory ground will be established to regularly conduct annual inspections on banks' models for forecasting estimated loss. Banks will be required to assess the adequacy of their loss forecasting models every year through verification by an independent organization and submit results to the FSS. Then, authorities can demand an improvement if the results are deemed insufficient.

FURTHER PLAN

Regarding the banking sector's capital adequacy requirements, authorities plan to draw up more detailed measures in the first half of this year and pursue regulatory improvements from the second half. Regarding the changes in banks' loss reserve requirements, authorities will complete a revision to the regulations on supervision of banking business, currently underway, and implement in the first half of this year.

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[5] For corporate loans, banks are required to accumulate a minimum level of allowance by classification of quality for assets: (a) 0.85% of "normal" assets, (b) 7% of "precautionary" assets, (c) 20% of "substandard" assets, (d) 50% of "doubtful" assets, and (e) 100% of "presumed loss."