Financial Services Commission

Press Release

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AUTHORITIES PLAN TO PREEMPTIVELY RESPOND TO REAL ESTATE PF RISKS OF SECURITIES FIRMS

The Financial Services Commission and the Financial Supervisory Service announced measures to preemptively respond to risks for securities firms related to real estate project finance (PF). Based on the improved market conditions, the measures are aimed at minimizing risks related to securities firms' exposure to PF and avoid a repeat of last year's market disruption.

BACKGROUND

In the second half of last year, a sharp rise in CP rates caused by short-term money market crunch made it difficult to refinance real estate PF-ABCPs backed by securities firms, and this has subsequently increased liquidity risk across the securities industry and spread more anxiety throughout financial markets.

To stem further spread of market jitters, the financial authorities actively responded to the crisis. Along with the purchase of corporate bonds and CPs through the Korea Securities Finance Corporation and the Korea Development Bank, authorities provided KRW1.8 trillion in liquidity jointly with the securities industry to purchase PF-ABCPs and issued an administrative interpretation for securities firms to help reduce refinancing demand for PF-ABCPs.

While real estate PF-related risks of securities firms have been kept at a manageable level with money market conditions being gradually stabilized, there still exist risk factors in the event of deteriorated market conditions. The delinquency rate of real estate PF loans by securities firms[1] is expected to continue to rise amid uncertainties over interest rate moves in global financial markets. The size of PF-ABCP guarantees remains similar to that at the end of last year.[2]

Against this backdrop, the FSC plans to take preemptive measures jointly with the securities industry to mitigate risks related to real estate PF and review how risk weights are applied when calculating securities firms' net capital ratios (NCRs) to ensure their PF-related risks are properly managed in accordance with actual risks.

MEASURES

1. MATURITY MISMATCH TO BE ADDRESSED THROUGH CONVERSION OF SHORT-TERM PF-ABCPS INTO LONGER-TERM LOANS

[1] PF loans by securities firms amount to KRW4.5 trillion with the delinquency rate of 10.38% (end-2022).
[2] Securities firms' credit exposure to PF (trillion won): 20.2 (end-October 2022), 21.5 (end-December 2022), 20.8 (end-March 2023)

Financial authorities will incentivize securities firms to convert their short-term real-estate PF-ABCPs into longer-term loans with maturities matching the duration of the real estate projects. Currently, there exist maturity mismatch problems between real estate projects, which usually run for one to three years, and the ABCPs financing them, which typically require refinancing every one to three months. That exposes securities firms to the risk of surging interest rates in refinancing their ABCPs in the event of a short-term money market crunch. Securities firms are likely to face increased risks if they fail to refinance ABCPs.

To address this maturity mismatch problem, financial authorities will encourage securities firms to convert their asset-backed securities including PF-ABCPs into longer-term maturity loans by lowering the application of risk weight on their net capital ratio for loans from the current level of 100 percent to 32 percent, which is about the same level of risk weight applied on the purchase of self-guaranteed ABCPs.

Out of more than KRW20 trillion in property-related asset-backed securities held by securities firms, about KRW 4.9 trillion of short-term debt will be converted into loans, according to the estimates by the Korea Financial Investment Association.

2. WRITE- OFFS OF NON-PERFORMING LOANS TO BE EXPEDITED

Financial authorities will help securities firms to speedily write off non-performing loans to ensure prudential management of securities businesses. Although the volume of real estate PF loans by securities firms remains not too high, standing at about KRW4.5 trillion, their delinquency rates have surged with a recent slump in real estate markets, raising concerns about the soundness of the securities industry.

In this regard, for assets classified as "estimated losses," securities firms will be encouraged to apply for write-offs as soon as possible. The FSS will ensure a swift review and approval process.[3]

3. LIQUIDITY SUPPORTS TO BE EXTENDED

The FSC will extend the period of operating the PF-ABCP purchase program of KRW1.8 trillion, which was launched at the end of last year and scheduled to terminate at the end of this month, until February next year. The program has significantly contributed to stabilizing PF-ABCPs backed by securities firms and the overall short-term money markets. During the market crunch at the end of last year, the program set a sufficient scale of liquidity provision, exceeding the total amount of ABCPs guaranteed by small and medium-sized securities firms (approximately KRW1.5 trillion) and purchased the entire amount of PF-ABCPs on sale (KRW504.5 billion).

In addition, the eased NCR risk weight (lowered to 32 percent) applied on the purchase of self-guaranteed PF-ABCPs currently in place and scheduled to expire at the end of June will be available until the end of this year. The lowering of NCR risk

[3] Securities firms are required to conduct an asset quality classification quarterly and submit applications for write-offs to the FSS a month before the end of each quarter.

weight to 32 percent helped to prevent a potential fire-sale of asset-backed securities by securities firms at the end of last year when money market credit situations turned worse. Given that money market situations have yet to completely make a turnaround, the eased NCR risk weight measure will be available until the end of this year.

4. Risk Weights to Securities Firms' NCR to be Reassessed

Apart from the temporary measures mentioned above, the financial authorities will reassess how risk weights are applied when calculating securities firms' net capital ratio (NCR), particularly in regard with real estate PF.

Under the current system where a securities firm's NCR risk weight is deducted by 100 percent for loans and 18 percent for ABCPs, regardless of the actual risk of real estate projects, debt priority or risk tolerance, securities firms are incentivized to finance real estate projects more in the form of ABCPs—rather than through long-term loans—despite the problem of maturity mismatch with underlying assets (already discussed above). Small and medium-sized securities firms even showed a tendency to expand their handling of high-risk PF instruments in search for high returns.

The FSC plans to improve the method of applying risk weights on real estate PF to minimize such regulatory arbitrage existing between the two different types of financing, while considering the actual risk tolerance of securities firms by size, stages of real estate projects and debt priority.

Further Plan

The measure for encouraging conversion of PF-ABCPs into longer term loans will take effect immediately with a no action letter issued by the FSS. Prompting early application for writing off non-performing loans will take place on a quarterly basis. Authorities plan to carry out the procedure needed to extend the availability of the PF-ABCP purchase program and the eased NCR risk weight on the purchase of self-guaranteed ABCPs by May and June, respectively. Meanwhile, financial authorities will finalize specific details regarding how to improve the NCR risk weight on real estate PF within this year and decide on their implementation period while taking into account conditions in the real estate market.

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For press inquiry, please contact Foreign Media Relations at fsc_media@korea.kr.