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Press Release

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MACRO-PRUDENTIAL STABILITY LEVY

Background

The Korean government plans to impose Macro-prudential Stability Levy (“the Levy”) on non-deposit foreign currency liabilities with three motivations.

First, the key factor of the past two financial crises in 1997 and 2008 was sudden capital outflows following excessive capital inflows during boom periods. Like many other emerging and developing countries with a small and open economy, Korea is highly vulnerable to changes in the global economy and sudden capital movements. Of the various capital flows, overseas borrowings are the most volatile, in particular short-term ones. The Korean government, which has reinforced macro-prudential measures to reduce volatility in capital movement within the framework of an open and liberalized economy, now decided to introduce the Levy.

Second, the need to curb massive capital inflows in the form of carry trade into Korea is growing as global liquidity has been rapidly increased by Quantitative Easing measures (QE) and the exceptionally low interest rates in advanced countries. A surge of capital inflows could lead to inflation and asset price bubbles, and a sudden reversal of such inflows could possibly result in a systemic risk.

In addition, the Levy will be used as to provide liquidity when necessary to help the Korean economy cope with external shocks.

The introduction of the Levy is consistent with the global trend, in particular with the communiqué of the G20 Seoul summit where the leaders have agreed on the need for design and implementation of macro-prudential measures to curb excessive capital flows. Germany, the United Kingdom and France are about to impose the financial levy from January 2011 with the aim of repairing the financial system or procuring resolution fund. Against this backdrop, the Korean government plans to adopt the Levy as a pre-emptive and precautionary measure to stabilize both financial market and economy as a whole.



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Key characteristics of the Levy

1. Imposition

In order to strengthen macro-prudential supervision and promote stability of the financial system in the economy, it was named Macro-prudential Stability Levy.

The Levy will be firstly charged on non-deposit foreign currency liabilities or total foreign currency-denominated debt exclusive of foreign currency-denominated deposits. The Levy on foreign currency liabilities reflects Korea's systemic risks which have been posed mainly by external factors such as excessive capital flows.

The authorities will carefully consider the application of the levy to non-deposit won-denominated debt by closely monitoring further international discussions on the Levy and domestic financial market conditions.

The Levy will be charged on the period average balance of non-deposit foreign currency liabilities held at financial institutions.

As of October, such foreign debt of local banks totaled \$168.9 billion. For local branches of foreign banks it was \$104.6 billion.

To avoid the double imposition, foreign currency denominated deposits will be left out of the rule as they are applied by Deposit Insurance System.

Liability accounts, such as Unpaid Spot Exchanges, Losses on Valuation of Derivatives and Borrowings for Sub-loan, that are used temporarily in the foreign currency transactions are not for borrowing, and thereby excluded.

For equal treatment between banks and non-bank financial institutions and prevention of backdoor funding, the Levy will be basically applied to all financial institutions (by Law). However, the new rule will firstly apply to banks, considering that they represent a large portion of the foreign currency business and highly contributed to cause systemic risk (by Enforcement Decree).

As of September 2010, non-deposit foreign currency liabilities held at banks accounted for 96.2% of non-deposit foreign currency liabilities held at all financial institutions.

Under the basic principle that the levy should not pose excessive burden on financial institutions' borrowing of foreign currency, the authorities will differentiate the rates by maturities of the debt to guide banks to motivate long-term borrowing.

The actual Levy rate will be determined through consultations with experts and interested parties as well as an analysis of policy effects and burden on financial institutions.



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2. Collection and Administration

Financial institutions will be required to pay the Levy in the U.S. dollar. The Levy fund will be launched inside the Finance Ministry's exchange equalization fund and accounted separately.

The money from the Levy could be used to provide foreign currency liquidity to distressed financial institutions during future crises and be invested in overseas assets during normal times in a way equivalent to foreign reserves are invested.

The Ministry of Strategy and Finance will be responsible for the Levy fund and the Bank of Korea will be commissioned to collect and administrate the fund.

In an effort to expand relevant infrastructure, the authorities will make an overhaul of the electronic reporting system for an accurate grasp of foreign currency debts held at financial institutions and strengthen sanctions against violations of the duty to report foreign currency transactions.

Next Steps

The related legislation will be submitted to the National Assembly next February and is envisaged to take effect from the second half of next year.

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