

South Korea: Foreign Currency Liquidity Regulations

Following months of speculation that the South Korean officials would introduce measures to curb short-term external foreign currency borrowing in the banking sector, the Financial Services Commission (FSC) issued new regulations on the matter on Thursday (19 Nov). However, the new regulations will not be applicable to the branches of foreign banks operating in South Korea. The clarification has helped to remove some uncertainty for these foreign branches which have traditionally depended on funding from their headquarters and the restrictions would have raised concerns about their viability.

The key measures unveiled on Thursday include: 1) local and foreign banks will not be allowed to trade FX forwards worth more than 125% of the value of underlying exports with clients; 2) banks to hold at least 2% of their total foreign-currency assets in foreign treasury bonds rated A or above, or other safe-haven investments effective July 2010; 3) minimum ratio of long-term foreign financing to long-term lending at local banks will be raised to 90% from current 80% beginning 2010. The ratio will be raised to above 100% during 1H10; 4) asset management companies will be required to provide various options to hedge FX exposure on overseas investment fund products they sell.

The new regulations will help ensure better foreign exchange risk management at the local banks and are in line with the measures to stabilise the financial and FX markets following the collapse of Lehman in September 2009 which include swap arrangements with other central banks as well as the supply of foreign currency liquidity to the financial institutions. In particular, measure 2 will help to reduce upward pressure on the KRW as a result of hedging activities by South Korean shipbuilders and exporters while measure 3 will help to reduce the banks' dependence on short-term funding which created significant pressure on the local financial system as USD-liquidity was drying up during the crisis. According to the FSC, most of the financial institutions meet the new requirements which mean scope to tighten the regulations further.

Market Implication

Market reaction to the new regulations was fairly muted as they were largely within expectations following a draft plan in September. In fact, the announcement has provided greater clarity given the ongoing speculations. Besides the new regulations, the FSC also said Thursday that it would be looking into USD-carry trade which is blamed for the volatility in the FX market. Taken together, the measures are expected to help cap the downside for USD/KRW. The pair ended Thursday 0.4% higher at 1,157.20 and continued to trade slightly higher today. We are maintaining our year-end target for USD/KRW at around 1,180.