FINANCIAL SUPERVISORY SYSTEM IN KOREA

- POLICY RESPONSES DURING THE CRISIS -

July 5, 2012

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Financial Services Commission

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<1> The principles of reform
- Causes of economic crisis in 1997 -

Public Sector

Inefficiency
&
Lack of transparency

Corporate Sector

Excessive investment
&
High debt ratio

Crisis

Labor Sector

Frequent labor disputes
&
Inflexible labor market

Financial Sector

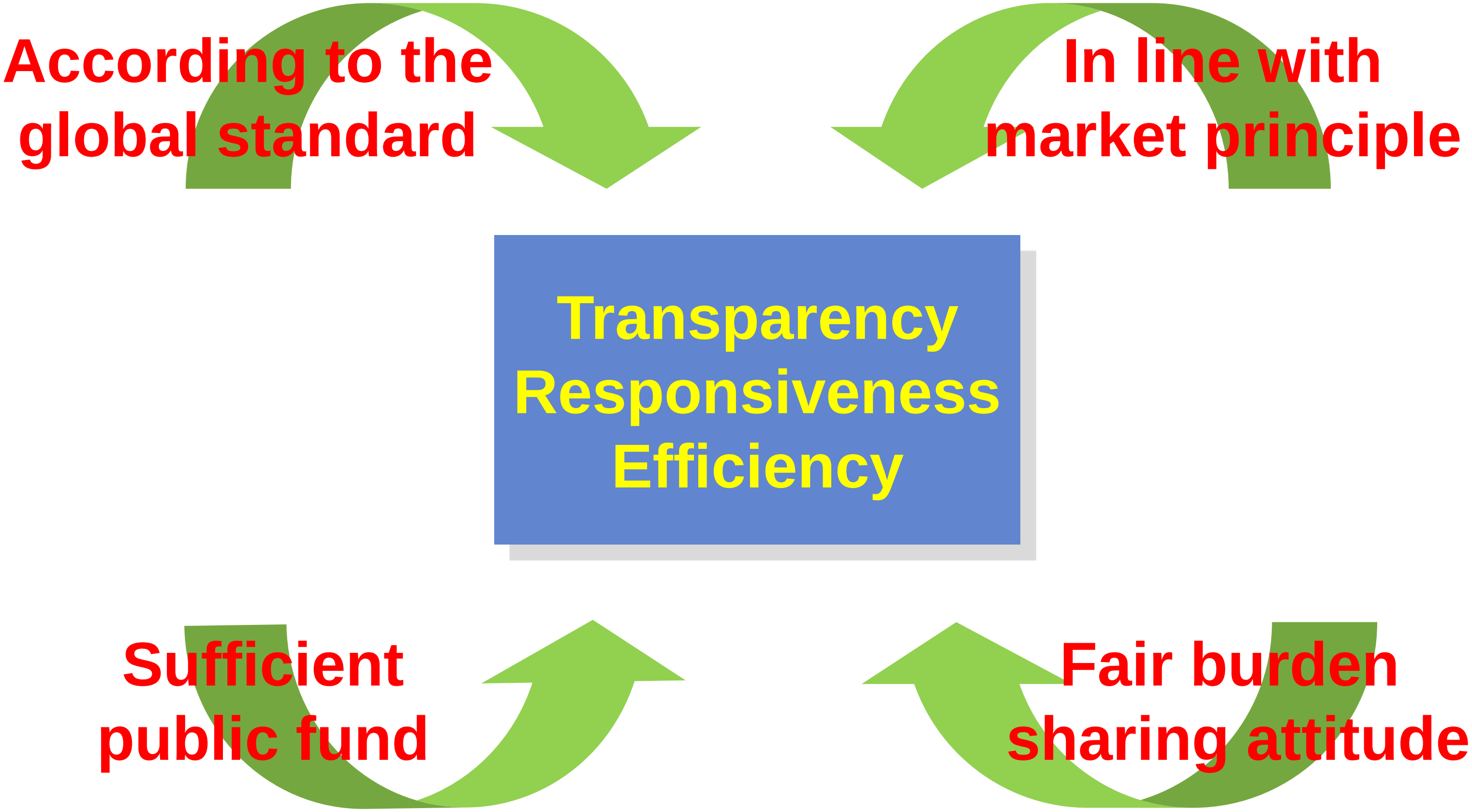
Lack of systemized
loan making
decision process

<1> The principles of reform
- The principles of Economic Reform (1) -

Financial	Restoration of financial intermediary functions
Corporate	Enhancement of corporate accounting practices and corporate governances
Public	Improvement of transparency and efficiency through privatizations
Labor	Resolution of labor disputes based on law & Promotion of flexible labor market

The ultimate goal is achieving competitiveness.

<1> The principles of reform
-The principles of Economic Reform (2) -

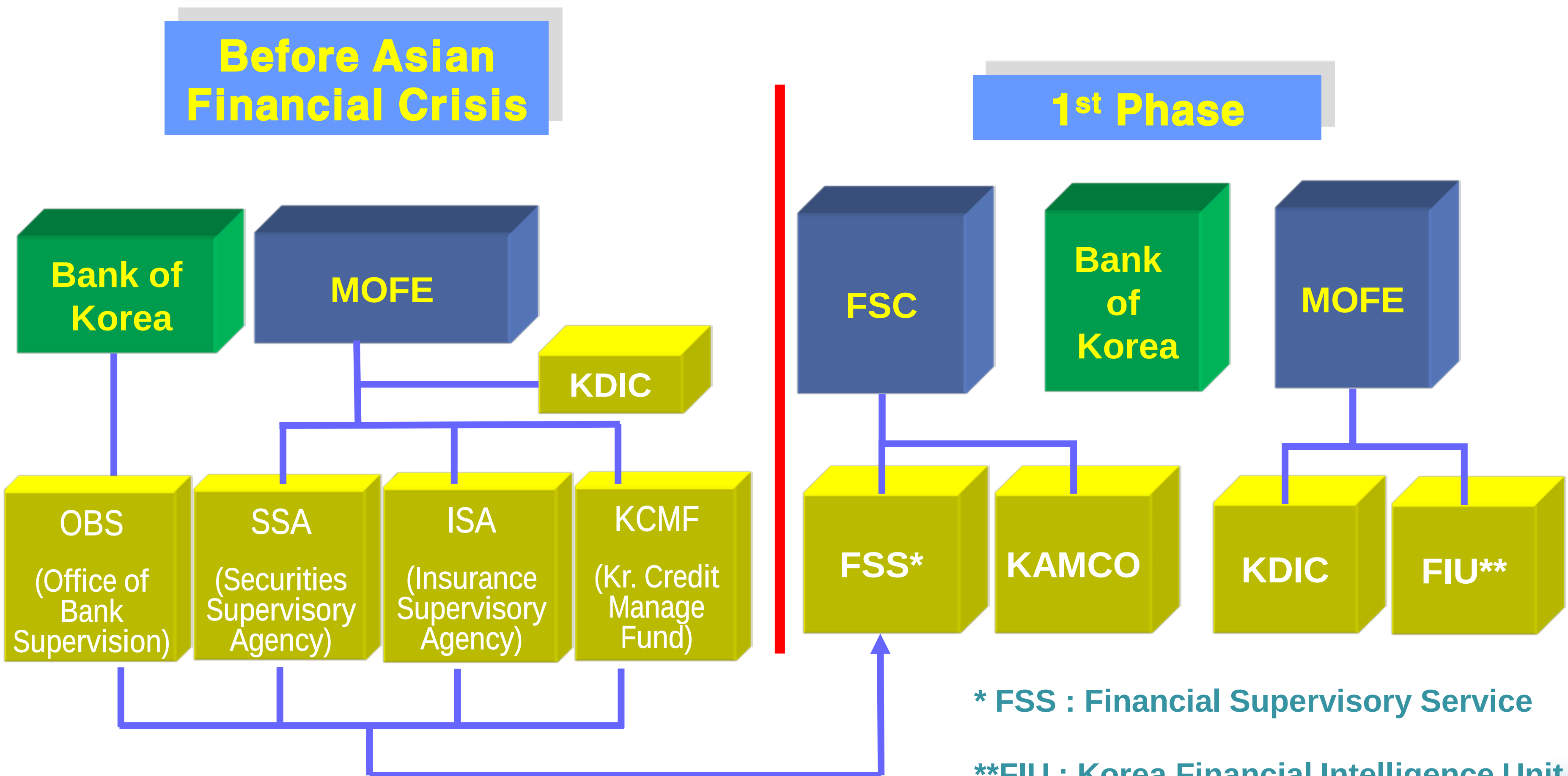


<2> Enhancement of financial supervisory role
- Relevant laws for financial sector restructuring-

Financial Supervisory Organization	Establishment of Financial Services Commission Act ➢ Enhancing financial supervisory role
Financial sector Restructuring	Structural Improvement of Financial Industry Act Public Fund Management Act
Disposition of NPAs and the Establishment of KAMCO	Effective Management of Non-Performing Assets of Financial Institutions and Establishment of Korea Asset Management Corporation Act ➢ Establishing NPA fund
Protect depositors and financial stability	Depositors Protection Act ➢ Establishing Deposit Insurance Fund and Deposit Insurance Bond Repayment Fund

<2> Enhancement of financial supervisory role (1)

(1st Phase 1998.4 ~ 2008.3)

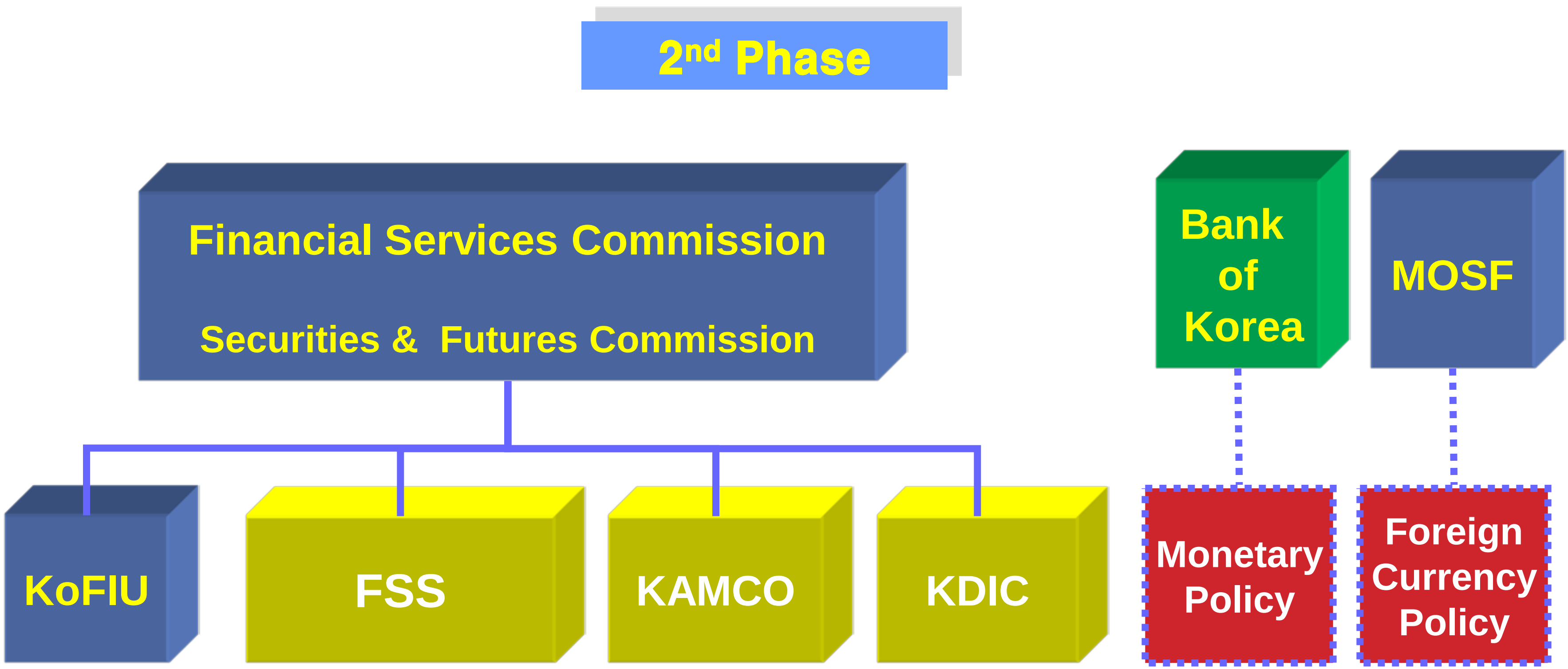


* FSS : Financial Supervisory Service

**FIU : Korea Financial Intelligence Unit

<2> Enhancement of financial supervisory role (2)

(2nd Phase 2008.3 ~ present)



<3> Integrated Financial Supervisors (1)

Financial Services Commission (FSC)

Established in April 1998(Changed name from Financial Supervisory Commission)

Separated from Ministry of Strategy and Finance
(Drafting regulations and Making policy in Financial Sector)

Independent Authority under the Prime Minister

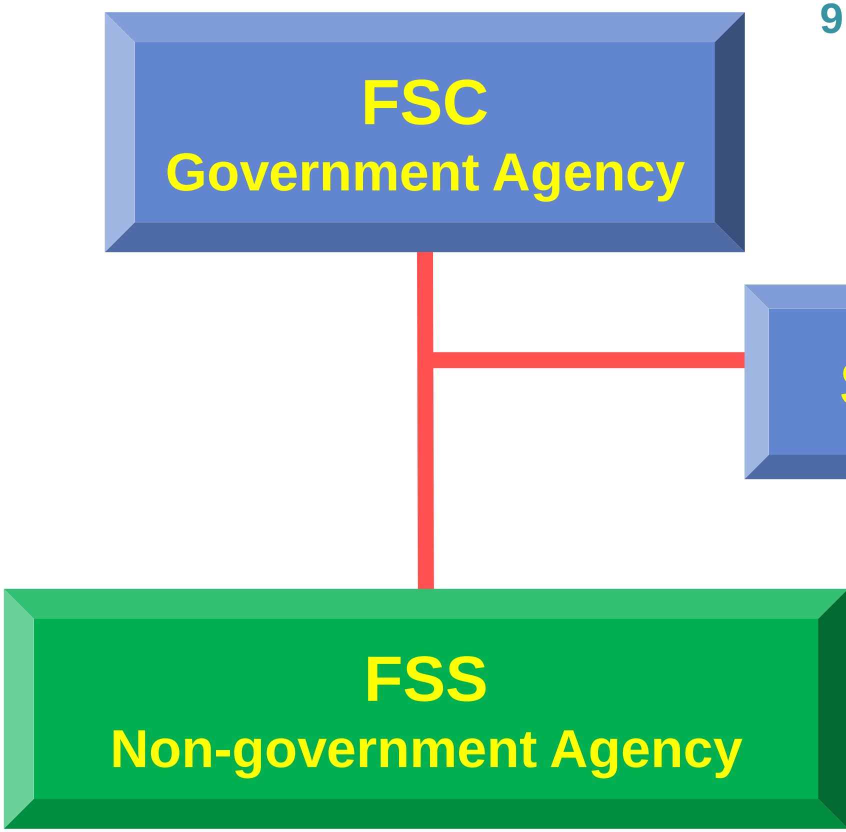
Financial Supervisory Service (FSS)

Established in January 1999

Integrated with four different supervisory authorities
- **Banking Supervisory Authority**
- **Securities Supervisory Authority**
- **Insurance Supervisory Authority**
- **Non-Banking Supervisory Authority**

<3> Integrated Financial Supervisors (2)

<Officers in FSC, SFC and FSS>



9 Commissioners

- Chairman, - Vice Chairman
- 2 Standing Commissioner
- 5 Non-standing Commissioners
- 231 Staffs

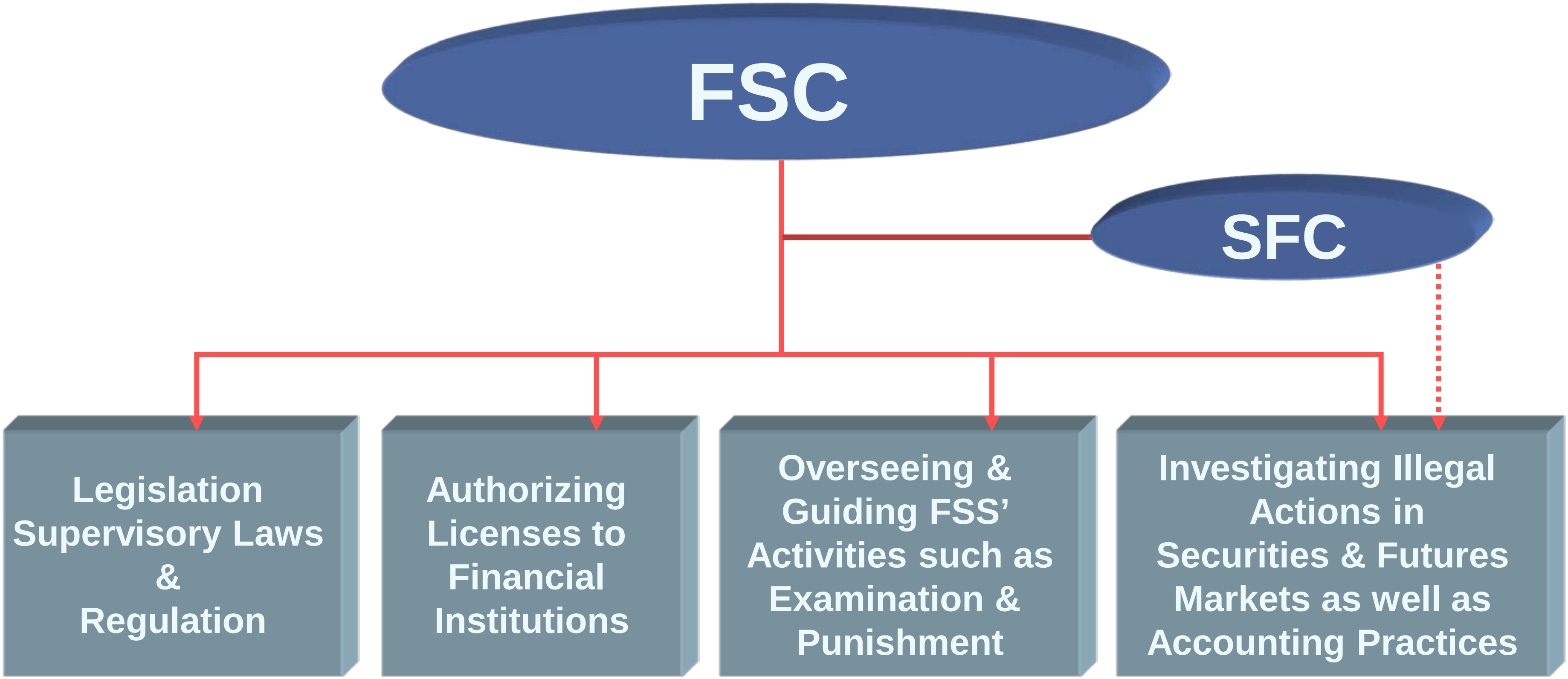
5 Commissioners

- **Chairman** (Vice Chairman of FSC)
- 1 Standing Commissioner
- 3 Non-standing Commissioners

- Governor
  - 3 Deputy Governors
  - 8 Assistant Governors
  - 1 Standing Auditor
  - 1,556 Staffs

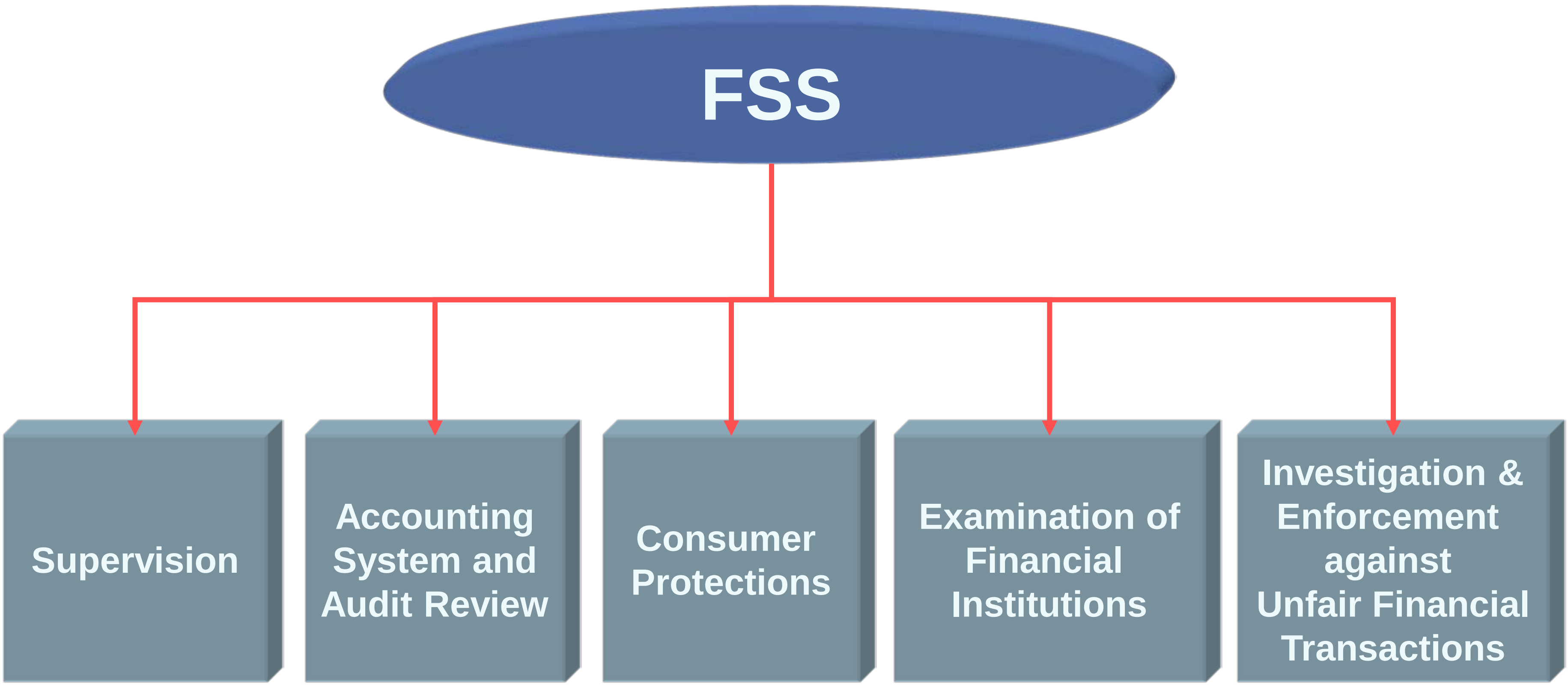
<3> Integrated Financial Supervisors (3)

(Responsibilities of FSC & SFC)



<3> Integrated Financial Supervisors (4)

(Responsibilities of FSS : Non-government Entity)



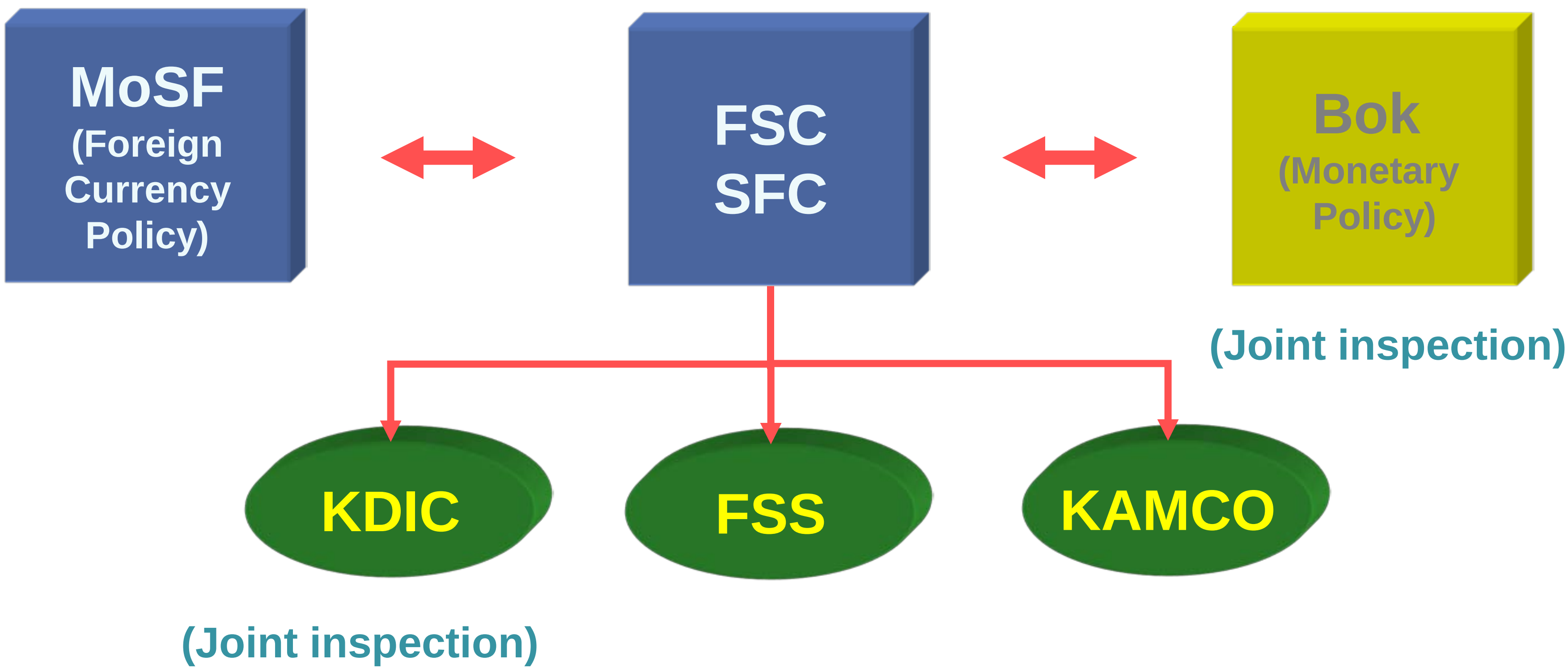
<3> Integrated Financial Supervisors (5)

(Funding Sources)

FSC	Government Budget (from General Accounting) - Budget in 2011 : 10.7 billion won
FSS	Contribution from BOK Fees from supervised financial institutions Fees for the issuance of securities - Budget in 2011 : 263.2 billion won

<3> Integrated Financial Supervisors (6)

(Cooperation with Other Authorities)



<3> Integrated Financial Supervisors (7)

(Two pillars of financial sector restructuring)

KDIC

- Injects public fund
- Protects depositors
- Manages deposit insurance fund

Ailing financial institutions

KAMCO

- Resolves NPLs
- Supports corporate restructuring
- Manages distressed assets fund

2. Risks and Challenges Raised during the Crisis

&

Policy Responses

Risks and Challenges

Risk Factors	Effects
#1 ***Lack of FX liquidity***	▪ High current external debt to FX reserves ratio ▪ Reduction of FX reserves ➡ Increased pressure on FX liquidity for Korean banks with large amount of short-term external debts
#2 ***Rapid economic recession***	▪ Global economic recession ➡ Decrease in exports & slowdown in domestic consumption ➡ Negative economic growth
#3 ***Possible deterioration of private sector***	▪ Fall in incomes & real estate prices ➡ Possible deterioration of households ▪ Economic recession, credit crunch ➡ Possible deterioration of corporate sector
#4 ***Possible deterioration of banks' soundness***	▪ Non-performing household and corporate loans, loss of principal investment ➡ Deterioration of capital soundness ▪ High loan-to-deposit ratio, short term funding ➡ Funding mismatch ➡ Liquidity problem

Policy Framework

Initial Response after the Lehman shock

#1 FX Market Stabilization

- Payment guarantee of foreign currency borrowings by domestic banks: $100 bn
- Currency swap lines with U.S., Japan, and China: $30 bn each / $90 bn in total
- $55 bn foreign liquidity provision by the BOK and the government

Medium-term Responses: Key Framework

#2 Fiscal Stimulus Package

- Won liquidity provision: 23.3 tn won
- Total Stimulus package: 7.4% of GDP (4.3% in 2009)

#3 Corporate Sector Liquidity Provision

- Extension of SME loans and guarantees due 2009
- Creation of Bond Market Stabilization Fund (10 tn won)

#4 Enhancing Banks' Soundness

- Launching of Bank Recapitalization Fund: 20 tn won
- Purchase of banks' bad assets through Restructuring Fund by KAMCO (40 tn won)
- Financial Stabilization Fund

#5 Corporate Restructuring

- Creditor financial institution-led restructuring
- Market-based restructuring

#6 Social Safety Net

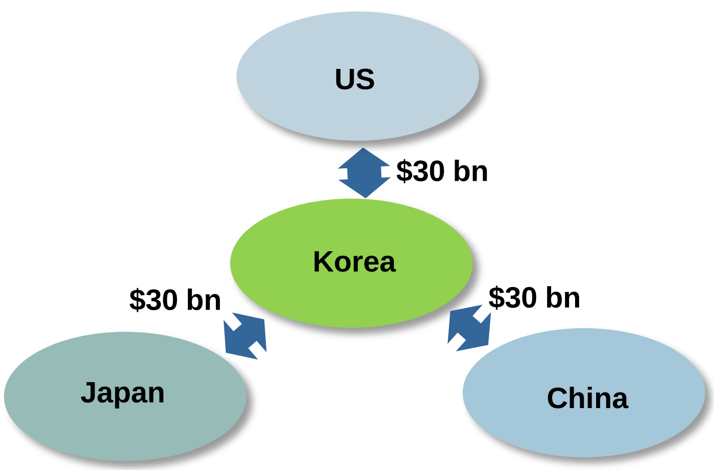
- Financial support through Miso Credit Foundation
- Credit recovery support for low-income households through debt restructuring and refinancing at lower rates

1 FX Market Stabilization

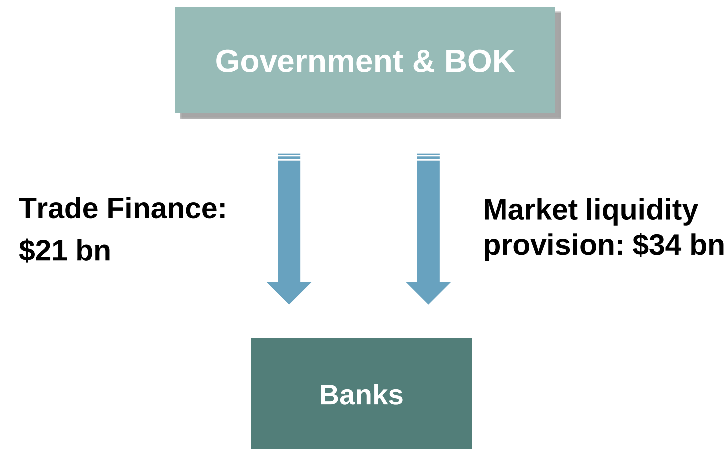
Currency Swap Lines : $90 bn

- Set up $30 bn currency swap line with the U.S. (Oct. 2008) and expanded existing currency swap lines with Japan an China to $30 bn each (Dec. 2008)

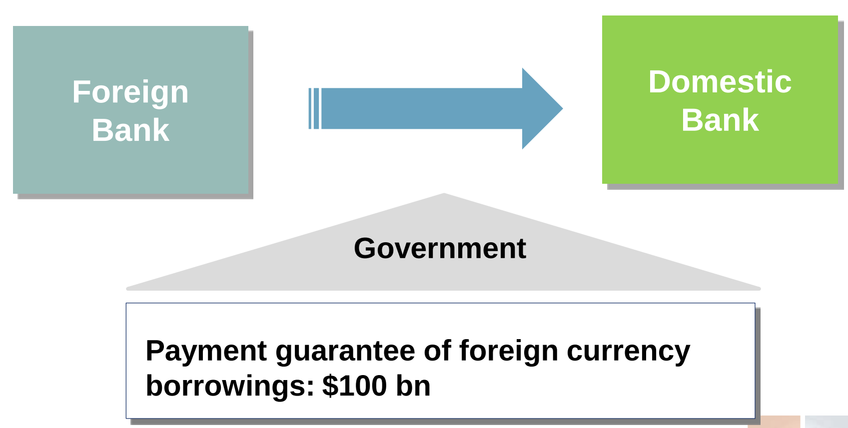
➡ Decisive role in resolving concerns over Korean financial institutions' FX liquidity conditions



Foreign Liquidity Provision : $55 bn



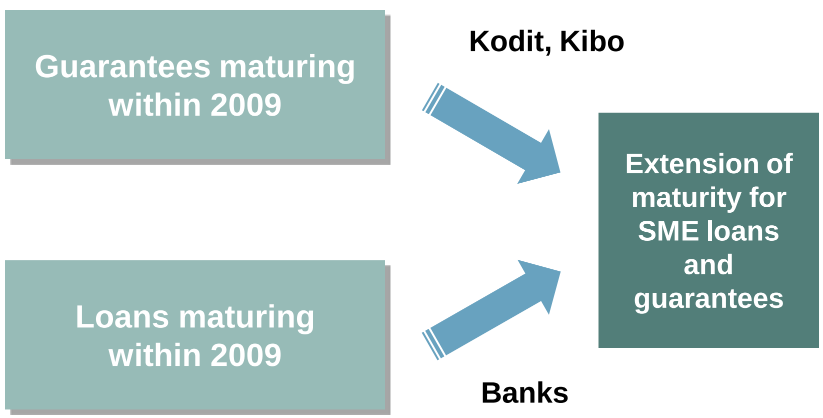
Payment Guarantee



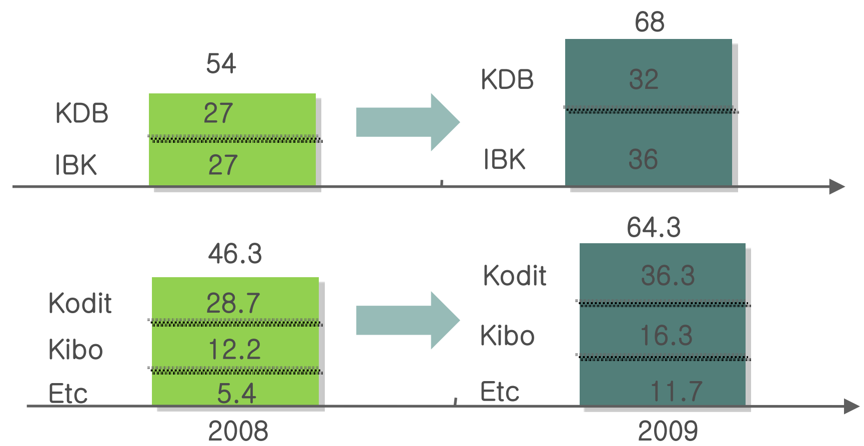
2 Corporate Sector Liquidity Provision

Extension of SME loans and guarantees

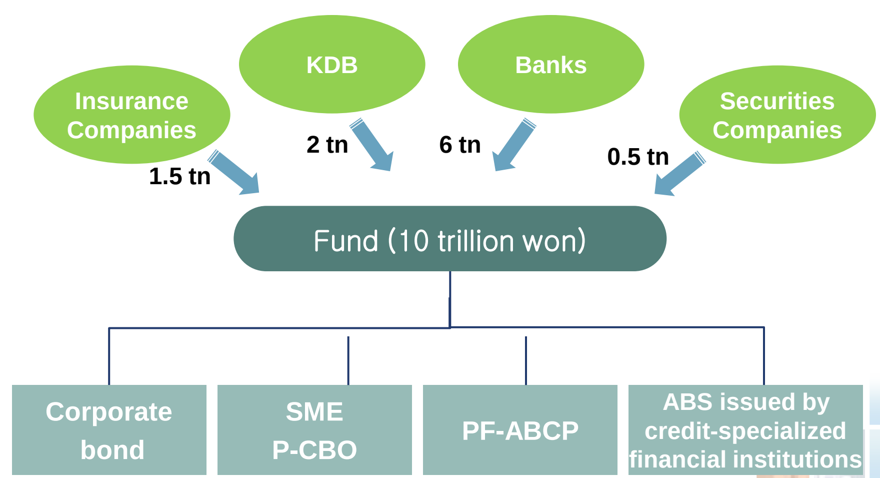
- **Maturity extension of guarantees provided by public guarantors till end-2009**
- **Maturity extension for SME loans falling due within 2009**
- **Review standards and limits eased for new loan guarantees and required process expedited**



Policy Banks & National Guarantors(trn, won)



Creation of Bond Market Stabilization Fund (10trn. won)



3 Enhancing Banks' Soundness

Asset Soundness Improvement

KAMCO

-Purchase of non-performing PF loans of banks and savings banks

Corporate Restructuring Fund

- Purchase of NPLs
- Purchase of assets of companies under restructuring
- 40 tn won
-Operation till 2014

Purchase of troubled assets

Purchase of troubled assets

Recapitalization

20 tn won Bank Recapitalization Fund

- Bank-specific credit limit, withdrawal when necessary
- No government intervention in banks' shareholders' right and management right

Banks' self-recapitalization (18 tn won)

Financial Stabilization Fund

- MOUs to boost SMEs and real sector support
- Fund size to be decided

Recapitalization

Recapitalization

Non-banks | Banks | Non-banks

Normal

(Potential) Insolvency

KDIC

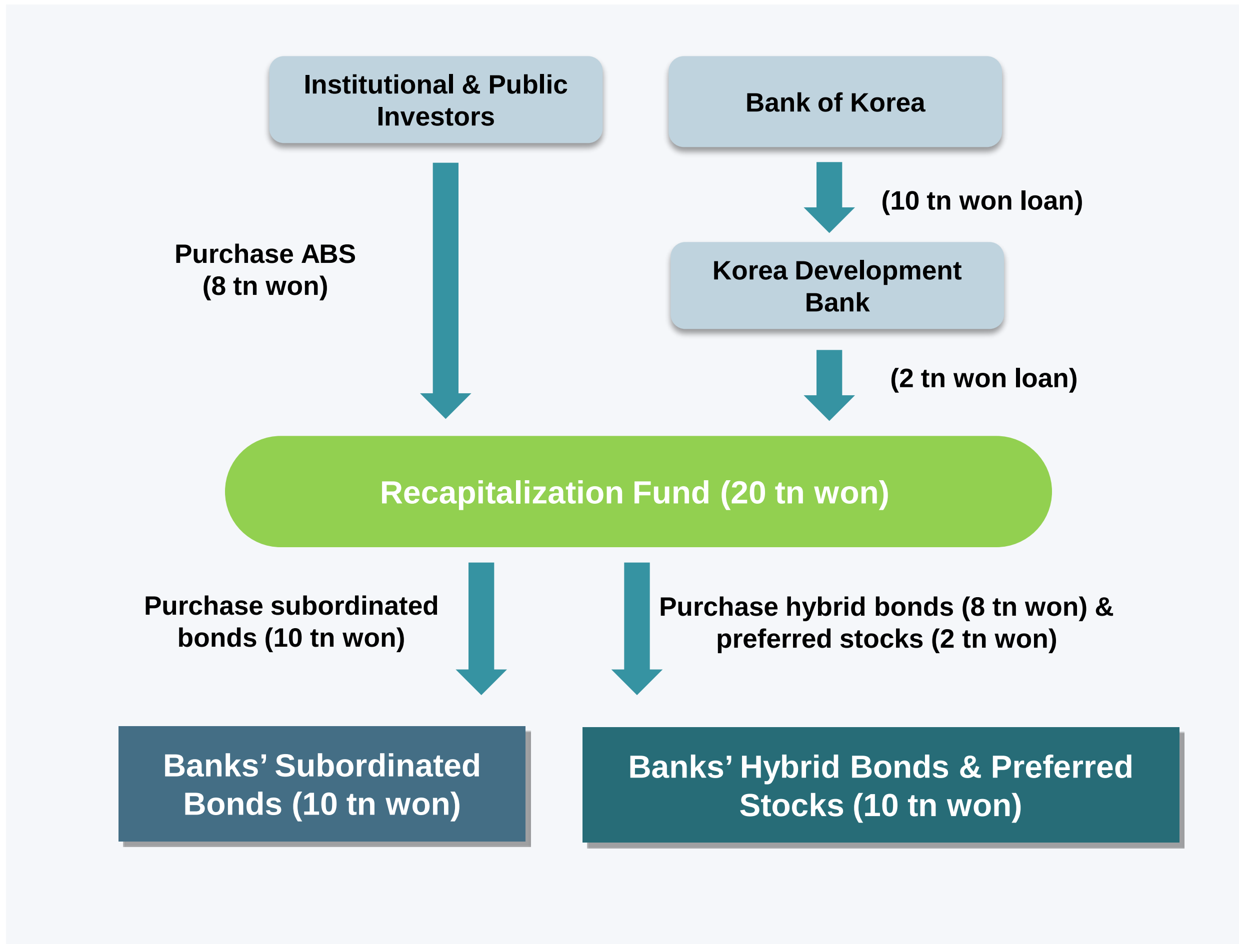
-Support through capital injection or contribution in kind
- Selling assets or merger with others

3-1 Bank Recapitalization Fund

Objective

- To improve capital adequacy without direct injection of government funds
- To encourage banks to actively support the real economy by increasing their loss absorption capacity
- To induce banks' active participation in corporate restructuring efforts (e.g. new funding support to workout firms)

Structure of Bank Recapitalization Fund



3. Lessons Learned

Lessons from the Crisis : Past and Present

Main Causes of the 1997 Asian Financial Crisis
▪ Excessive debts & lack of transparency in corporate sector ▪ Prevalent moral hazard caused by distorted lending practices of financial institutions & failure to adapt to rapid financial liberalization ▪ Lack of timely response (e.g., through restructuring) to the spread of risks in the international financial market ▪ Inadequate prudential regulations

Main Causes of the Current Global Crisis	
Stigma Effect	▪ Global investors' doubt over the Korean government's responses based on their past experience in 1997 ➡ Circumstances in Korea was thought to be worse than the actual situation
Non-Possession of Reserve Currency	▪ KRW weakened rapidly as financial institutions moved to USD ➡ Korea suffered more than it deserved as a country without reserve currency
Export-oriented Economy	▪ It was widely believed that export-oriented Korea would be hurt more as the global economic recession deepens

Comparison with Asian Financial Crisis

Korea's financial condition has improved vastly over the past ten years and the country is well-prepared to manage the current crisis

		Asian Financial Crisis (late 1997)	Global crisis
Causes		Internal factors such as corporate bankruptcy	External factors
Foreign Exchange	Foreign Currency Reserves	US$ 8.9bn	US$ 239.7bn [1]
	ST External Debt / FX Reserves	717%	79%[1]
	Liquid External Debt / FX Reserves	973%	95%[1]
	Total External Debt / FX Reserves	1,957%	177%[1]
Banks	Bank NPL Ratio	6.0%	1.1% [2]
	BIS Ratio	7.0%	12.31% [2]
Corporates	Corporate Debt Ratio	424.6%	106.5% [3]
	Corporate Interest Coverage Ratio	115.0%	404.8% [3]

[1] as of September 2008
[2] as of December 2008
[3] as of end of 2007

Self-Evaluation

Prompt and Honest Response

- Immediately after identifying signs of a crisis, the Korean government promptly prepared countermeasures in coordination among relevant ministries.
- With frank assessment of certain weaknesses, the government provided accurate and detailed information to investors to address misunderstandings and restore market confidence.

Management of Financial Sector Soundness

- Household and corporate loan delinquency rates managed at stable 1 percent-level ➡ Little possibility of massive banking sector defaults
- This is largely attributable to aggressive monetary and financial policies, including tight LTV/DTI regulations.

Past Restructuring Experience

- With an institutional framework (e.g., KAMCO and Korea Deposit Insurance Corporation) and a legal framework (e.g., Consolidated Insolvency Act and Corporate Restructuring Promotion Act) established since the 1997 financial crisis to deal with restructuring and resolution of NPLs, Korea responded to the crisis in a timely manner.

Sound Real Sector/Fiscal Fundamentals

- Since the 1997 financial crisis, Korean companies have continued to increase capital and lower debts.
- The government has maintained a sound fiscal position to be able to provide large-scale stimulus package in time.

Macro-Prudential Supervisory System

- Need to improve macro-prudential supervisory system to prevent herd behavior among market participants.

Lessons from the Crisis : Supervision Perspective

Crisis repeats itself

- **Given the complexity and interconnectedness of the global economy, crisis may come at anytime & in various forms**

  - Asian crisis(1997), Subprime(2008), Europe(2010)
  - Crisis can be "Disguised Blessings" if dealt correctly

Regulatory coordination is important

- **Inter-agency cooperation and information sharing is critical in crisis management**

  - Institutional framework established since the 1997 financial crisis helped to deal with the global financial crisis

Preemptive measures are necessary

- **Preemptive & prompt response mechanisms should be in place to effectively respond to crisis**

  - Resolution regime should be set-up in advance to ensure "smooth failing" & reduce spill-overs

Macro-prudential supervision

- **Macroprudential supervision is critical in ensuring stability of financial system as well as the real economy**

  - Need to develop macroprudential policy measures to contain procyclicality and herd behavior (e.g. LTV, DTI)

Future Policy Direction

Upgrade Korea's Position of Financial Sector