

**Asian Capital Market Law and Regulation Forum:
Japan, China and Korea**

Korea's Capital Market Supervision and Recent Developments

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FINANCIAL SUPERVISORY SERVICE

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I. Recent Market Developments

I. Recent Market Developments

Stock Market

Stock market on the rise since March

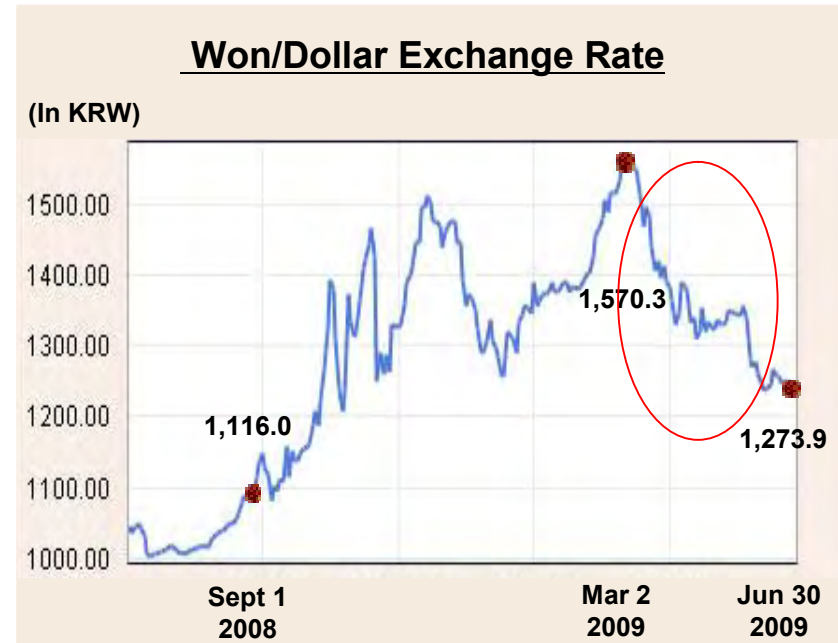
- Signs of market stability
- Active buying by foreign investors



Exchange Rate

Korean won gaining ground

- More stable international markets
- More longer-term foreign borrowing
- Rising current account surplus



I. Recent Market Developments

Interest Rate

Low interest rates

- Policy rate cuts by BOK
- Sufficient liquidity



“While the markets around the world are still reeling from the global financial crisis, signs of stability are returning to Korea’s financial markets”

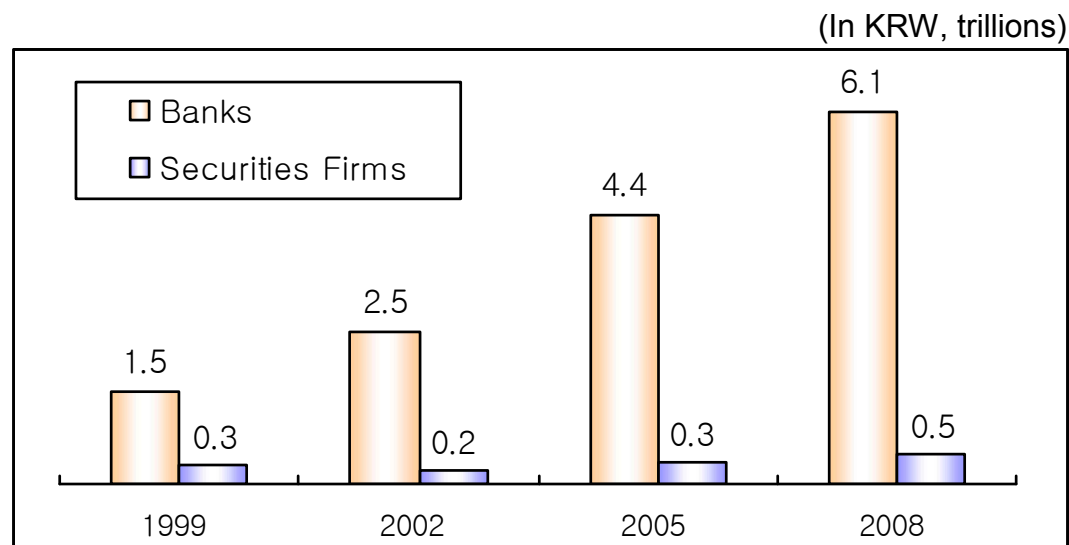


II. Financial Investment Services and Capital Markets Act (FSCMA)

II. FSCMA

1. Background

Average Capital: Banks and Securities Firms



- Bank-dominated market for decades
- Securities firms still primarily depend on brokerage for their income source, which indicates a need for business diversification into investment banking and others

FSCMA to help promote the competitiveness of the capital markets and the financial investment industry

II. FSCMA

2. Main Ideas of FSCMA

Comprehensive Definition of Financial Investment Products

Before

A long list of securities and derivatives products in relevant laws that financial firms are allowed to offer

- Positive-list system for financial products and services
- Only investors investing in those products and services are protected



After

Financial investment products are defined in broader terms

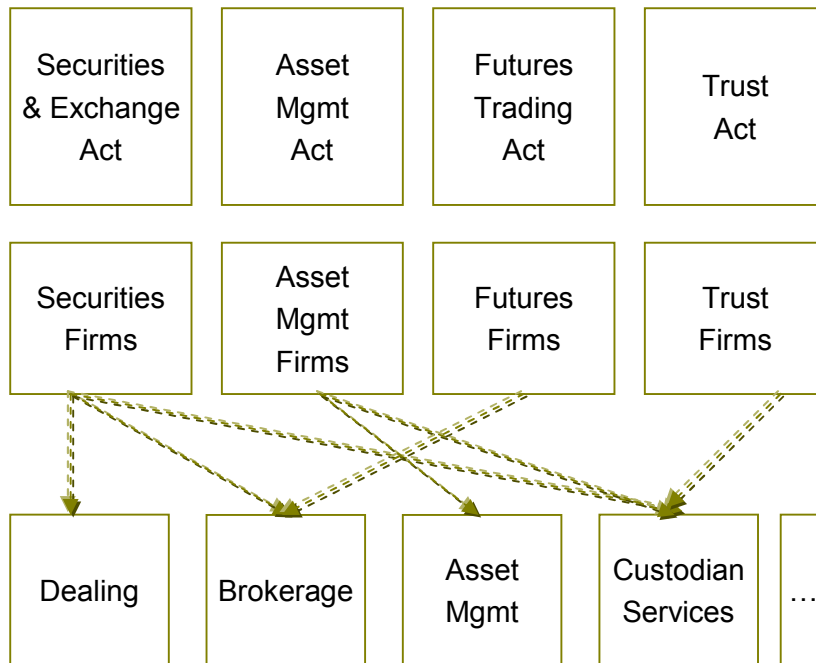
- Defined as financial products with possibility of principal loss
- Investors investing in any financial investment product are protected

II. FSCMA

2. Main Ideas of FSCMA

Transition to Function-Based Regulation

Sector-Based Approach



Function-Based Approach

Under FSCMA, a financial product or service is subject to the same regulatory treatment, regardless of who offer them: dealing, brokerage, asset management, discretionary and non-discretionary investment advisory services, and custodian service

II. FSCMA

2. Main Ideas of FSCMA

Expanded Scope of Business

Before

As a rule, financial investment companies were limited to a single regulatory license; for instance, an asset management company cannot engage in securities business



After

Financial investment companies now can engage in multiple areas such as dealing, brokerage, and asset management (subject to certain information barrier requirements)

II. FSCMA

2. Main Ideas of FSCMA

Measures to Enhance Investor Protection

- Investors are classified into two groups: ordinary vs. professional
- For ordinary investors, stricter investor protection rules apply
 - Know-your-customer rules
 - Principle of suitability
 - Duty to explain about financial investment products
- The following rules are both applicable to ordinary and professional investors
 - Prohibition of unsolicited calls
 - Prohibition of misleading investors with uncertain matters
 - Adoption of cooling-off period
 - Duty to manage conflicts of interest

II. FSCMA

3. Key Changes Expected under FSCMA

- Emergence of local investment banks with global competitiveness
- Synergy effects arising from engaging in multiple businesses
- New and innovative financial products and services
- More business opportunities with business specialization

Due to the global financial crisis and a significant increase in risk aversion, it may take some more time to see the expected changes under FSCMA taking place



III. Global Responses to the Financial Crisis

III. Global Responses to the Financial Crisis

1. What has happened?

- A global financial and economic crisis, triggered by a brutal re-rating of risk in core economies
- This re-rating revealed the under-capitalization of the financial system
- That, in turn, generated a panic
- This panic triggered a collapse in credit and consumer demand, which spread the crisis worldwide

III. Global Responses to the Financial Crisis

2. Why did this happen?

Excessive Liquidity

- Low real and nominal interest rates and “the reach for yield”
- Excessive mortgage lending

Short-termism & Risk Management Failures

- Innovation in the financial sector, to provide apparently safe, high-yielding assets
- Greater use of leverage with securitization and derivatives

Collapse of CDS Market

- Subprime mortgage risk concentrated in some financial firms issuing CDS
- Growing counterparty risk

Regulatory Failures

- Regulatory failures to effectively oversee innovative financial products
- De-regulation and mal-regulation of the financial system
- Procyclical implications of mark-to-market valuation and credit rating

III. Global Responses to the Financial Crisis

3. What actions are needed?

Discussions at G-20 and other international frameworks

- Prudential regulations
 - More and higher-quality capital, especially against trading risk
 - Countercyclical capital buffers
 - Stronger focus on liquidity
 - Regulation by economic substance, not legal form
- Oversight of OTC derivatives: standardization and resilience of credit derivatives markets, especially through CCP
- Soundness of financial firms' compensation policies
- More effective oversight of activities of CRAs
- Oversight of hedge funds



IV. Korea's Capital Market Supervision: In Line with Global Directions

IV. Korea's Capital Market Supervision

1. Prudential Regulation on Financial Investment Companies

Capital Adequacy

- Net capital ratio (NCR: liquid net capital / risk amount retained by a firm) should be 150 percent or over
 - Average NCR as of Mar 2009: 617%
- The calculation methodology of risk amount recently improved to better reflect operational risk, credit risk, market risk, etc. (Feb 2009)

IV. Korea's Capital Market Supervision

1. Prudential Regulation on Financial Investment Companies

Risk-Based Supervision

- Risk Analysis and Management System (RAMS)
- Introduced in July 2008
- For 12 business activities, financial investment companies are evaluated using both qualitative (risk management capabilities) and quantitative (risk exposure) criteria
- Evaluation on a monthly basis and time-series analysis
- Different follow-up actions are taken depending on evaluation results

IV. Korea's Capital Market Supervision

1. Prudential Regulation on Financial Investment Companies

Risk Matrix

	Brokerage	Dealing			Investment Banking			Others	Total
		Stock	Bond	Others		Underwriting	ABS	PI		
1. Risk Exposure										
Market risk									
Credit risk									
Operational risk									
Liquidity risk									
Risk rating (A)									
2. Risk Management Capabilities										
BOD									
Risk mgmt units									
Risk mgmt systems									
Internal controls									
Risk mgmt rating (B)									
3. Composite Rating: (A+B)/2										
Composite rating									

IV. Korea's Capital Market Supervision

1. Prudential Regulation on Financial Investment Companies

Management Evaluation Ratings

- Similar to CAMELS ratings used for banking supervision
- Introduced for securities and insurance firms in 1999
- Fine-tuned in July 2009 to accommodate changes under FSCMA
- Computed using both quantitative and qualitative criteria
 - Quantitative evaluations on a monthly basis
 - A significant drop in the monthly rating or capital deficiencies found during a quarterly quantitative evaluation triggers a qualitative evaluation
 - A poor management evaluation rating triggers prompt corrective actions

IV. Korea's Capital Market Supervision

1. Prudential Regulation on Financial Investment Companies

Management Evaluation Components

✓ Firm-wide evaluation (60%)

	Quantitative items	Qualitative items
Capital Adequacy (30%)	<ul style="list-style-type: none">• NCR II• Capital Ratio	<ul style="list-style-type: none">• Capital adequacy policies• Feasibility of capital maintenance plans
Earnings (20%)	<ul style="list-style-type: none">• ROA• Earnings efficiency ratio	<ul style="list-style-type: none">• Soundness of earnings volatility factors• Revenues/expenses allocation across business segments
Internal Controls (10%)	<ul style="list-style-type: none">• Internal control failure ratio	<ul style="list-style-type: none">• Internal control procedures• Internal control structure

IV. Korea's Capital Market Supervision

1. Prudential Regulation on Financial Investment Companies

Management Evaluation Components

✓ Business activity-specific evaluation (40%)

		Quantitative items	Qualitative items
Dealing & Brokerage	Liquidity (20%)	<ul style="list-style-type: none"> • (3-month) Liquidity ratio 	<ul style="list-style-type: none"> • Adequacy of funding liquidity • Liquidity management
	Asset soundness (20%)	<ul style="list-style-type: none"> • SBL ratio • Bank debt ratio 	<ul style="list-style-type: none"> • Risk management policies • Managerial soundness
Collective Investment	Liquidity (20%)	<ul style="list-style-type: none"> • Liquidity ratio • Fixed investment ratio 	<ul style="list-style-type: none"> • Adequacy of funding liquidity • Liquidity management
	Asset management (20%)	<ul style="list-style-type: none"> • Return against benchmark • Changes in AUM • Changes in fees received 	<ul style="list-style-type: none"> • CIS risk management • Portfolio management
(Real estate) Trust	Liquidity (20%)	<ul style="list-style-type: none"> • Liquidity ratio • Fixed assets ratio 	<ul style="list-style-type: none"> • Adequacy of funding liquidity • Liquidity management
	Asset soundness (20%)	<ul style="list-style-type: none"> • Risk-weighted assets ratio • SBL ratio 	<ul style="list-style-type: none"> • Adequacy of asset classification • Non-performing assets management

IV. Korea's Capital Market Supervision

1. Prudential Regulation on Financial Investment Companies

Stronger Focus on Liquidity

- Changes to the computation of short-term liquidity ratios (used for management evaluation ratings and RAMS) to give more consideration to actual cash flows
 - Assets to be converted into cash within the coming three (or one) months / liabilities to be repaid with cash within the coming three (or one) months

IV. Korea's Capital Market Supervision

1. Prudential Regulation on Financial Investment Companies

The Fundamental Principles of Financial Regulation (Geneva Report on the World Economy 11, January 2009)

- Capital regulations to better reflect liquidity risk
- Modified CAR = Basic CAR X System Risk Factor (maturity mismatch)
- Financial firms having an asset-liability maturity mismatch are typically exposed to funding liquidity risk; thus, they must be encouraged to set aside additional capital against maturity mismatches and rely more on longer-term funding

IV. Korea's Capital Market Supervision

2. Supervision of Derivatives Transactions

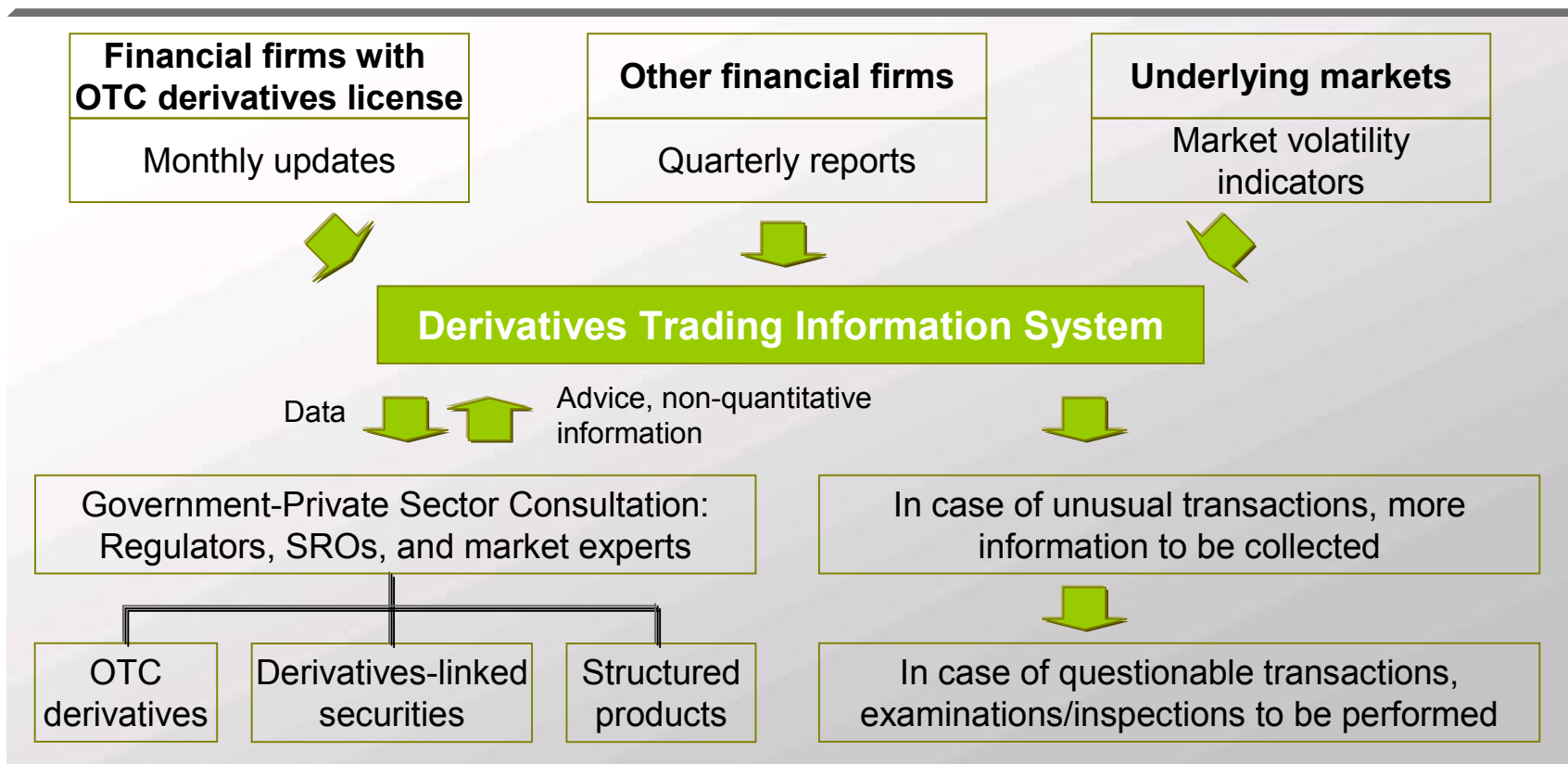
Derivatives Trading Information System

- To be introduced in 2009 to help ensure timely monitoring and regulatory responses
- To cover information related to financial firms' derivatives trading such as OTC derivatives, currency derivatives, derivatives-linked securities, and credit derivatives
 - Underlying assets, counterparties, reference entities, etc.
- To be used for stress testing to estimate losses under certain distressed market conditions

IV. Korea's Capital Market Supervision

2. Supervision of Derivatives Transactions

Derivatives Trading Information System





V. Regulatory Issues under Review

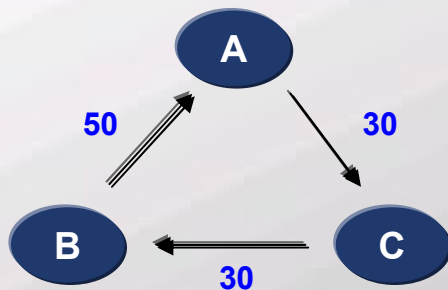
V. Regulatory Issues under Review

1. Supervision of Derivatives Transactions

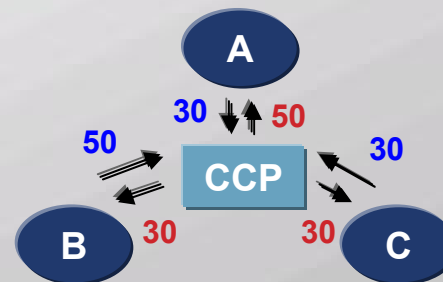
Central Clearing Counterparty

- Compared with an OTC bilateral market, a central clearing counterparty helps reduce counterparty risk significantly

OTC Bilateral Market



Central Clearing Counterparty



V. Regulatory Issues under Review

1. Supervision of Derivatives Transactions

Central Clearing Counterparty

- G20 leaders called for establishing CCPs for CDS
- In the US, clearing of all standardized OTC derivatives through regulated central counterparties may be required
- In Korea, an idea of clearing OTC derivatives through a central clearing counterparty is under review
 - A task force to come up with a road map in the second half of 2009

V. Regulatory Issues under Review

2. Sound Compensation Practices

G20 Principles

- Firms' boards of directors should play an active role in the design, operation, and evaluation of compensation schemes
- Compensation arrangements should properly reflect risk and be sensitive to the time horizon of risks
- Firms should publicly disclose clear, comprehensive, and timely information about compensation
- Supervisors will assess firms' compensation policies as part of their overall assessment of their soundness

In Korea, KOFIA and KCMI are working on a plan to ensure sound and reasonable compensation practices

V. Regulatory Issues under Review

3. Oversight on CRAs

G20 Recommendations

- All credit rating agencies should be subject to a regulatory oversight regime
- National authorities will enforce compliance and require changes to a rating agency's practices and procedures for managing conflicts of interest and assuring the transparency and quality of the rating process

- ✓ **All of the four credit rating agencies in Korea are subject to regulatory approval and regular examinations**
- ✓ **Changes to strengthen their internal controls are under consideration**



VI. The Way Forward

VI. The Way Forward

Cross-Border Supervision and Cooperation

- As global financial markets are increasingly interconnected, systemic risks and their spillovers are more likely
- Regulators across the world should work more closely together through IOSCO and other international regulatory frameworks
- China, Japan, and Korea should play a leading role in promoting regional cooperation



THANK YOU