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TECHNICAL NOTE

FINANCIAL CONGLOMERATES SUPERVISION

The content of this Technical Note is based on information available as of end-June/December 2019, before the global intensification of the COVID-19 outbreak. It focuses on the Republic of Korea's medium-term challenges and policy priorities and does not cover the outbreak or the related policy response, which has since become the overarching near-term priority.

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**Monetary and Capital Markets
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This Technical Note was prepared in the context of an IMF Financial Sector Assessment Program (FSAP) in Republic of Korea in August 2019 and December 2019 that was led by Udaibir Das. Further information on the FSAP can be found at <http://www.imf.org/external/np/fsap/fssa.aspx>

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Glossary

ARFP	Asia Region Funds Passport
AT1	Additional Tier 1
AUM	Assets Under Management
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles for Effective Banking Supervision
BoD	Board of Directors
BoK	Bank of Korea
CA	Commercial Act
CAMEL	Capital Adequacy, Asset Quality, Management, Earnings and Liquidity
CAMEL-R	Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, Risks
CCyB	Countercyclical Buffer
CEO	Chief Executive Officer
CET1	Common Equity Tier 1
CGA	Corporate Governance Act on Financial Companies
CIS	Collective Investment Schemes
CPFC	Consultation Papers on the Supervision of Financial Conglomerates
D-SIB	Domestic Systemically Important Bank
DART	Data Analysis, Retrieval and Transfer System
DLS	Derivative Linked Securities
DLF	Derivative Linked Funds
DRSIB	Detailed Regulation on Supervision of the Insurance Business
DRSBB	Detailed Regulation on Supervision of Banking Business
EDIBA	Enforcement Decree of the Insurance Business Act
ELS	Equity Linked Securities
ERIBA	Enforcement Rules of the Insurance Business Act
ESG	Environmental Social Governance
ESMA	European Securities and Markets Authority
FHC	Financial Holding Company
FHCA	Financial Holding Companies Act
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSC	Financial Services Commission
FSCMA	Financial Investment Services and Capital Markets Act
FSS	Financial Supervisory Service
FTC	Fair-Trade Commission
GDP	Gross Domestic Product
HFG	Holding Financial Group
IASB	International Accounting Standards Board
IBA	Insurance Business Act
ICAAP	Internal Capital Adequacy Assessment Process
ILAAP	Internal Liquidity Adequacy Assessment Process

ICP	Insurance Core Principle
IOP	IOSCO Objectives and Principles for Securities Supervision
IOSCO	International Organization of Securities Commissions
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IRB	Internal Ratings-Based Approach
KDB	Korean Development Bank
KDIC	Korea Deposit Insurance Corporation
K-ICS	Korea Insurance Capital Standard
K-IFRS	Korean International Financial Reporting Standards
KRW	Korean Won
LCR	Liquidity-Coverage Ratio
LTD	Loans-to-Deposits Ratio
MCCs	Mutual Credit Cooperatives
MCM	IMF's Monetary and Capital Markets Department
MID	Management Improvement Demand
MIO	Management Improvement Order
MIR	Management Improvement Recommendation
MMF	Money Market Fund
MOEF	Ministry of Economy and Finance
MOU	Memorandum of Understanding
MSBs	Mutual Savings Bank
NCR	Net Capital Ratio
NFG	Nonholding Financial Group
NGFS	Network for Greening Financial System
NPS	National Pension System
NSFR	Net Stable Funding Ratio
ODI	Other Deposit Taking Institution
ORSA	Own Risk and Solvency Assessment
PFCs	Joint Forum Principles for Financial Conglomerate Supervision
RAAS	Risk Assessment System
RBC	Risk-Based Capital
RSBB	Regulation on Supervision of Banking Business
RSIB	Regulation on Supervision of the Insurance Business
RWA	Risk-Weighted Asset
SIFI	Systemically Important Financial Institution
SIB	Systemically Important Bank
SFC	Securities and Futures Commission
SMEs	Small and Medium Enterprises

EXECUTIVE SUMMARY¹

Oversight of the Korean financial system is broadly effective. Korea's Financial Services Commission (FSC) and Financial Supervisory Service (FSS) have in place regulatory and supervisory regimes in line with international standards with only a few remaining gaps. The authorities have addressed most of the recommendations of the previous FSAP and made good progress in benchmarking their frameworks with the Basel Core Principles (BCP), the Insurance Core Principles (ICP) and the International Organization of Securities Commissions (IOSCO) Objectives and Principles for Securities Supervision (IOP).

The multiagency arrangement for financial system regulation has determined Korea's room for maneuver and policy choices in group supervision, in result contributing to a more restrictive system than international practice. Together, the FSC and the FSS are considered by the legislative framework as an integrated supervisory authority, although represented by two agencies. From an accountability point of view, the FSC—as part of the Government—oversees supervisory policies, legislation, as well as adopts legally binding decisions in supervision. The FSS is mandated with daily tasks of supervision and operates under the guidance of the FSC. Several protocols for cooperation and joint consultative groups have been set up among authorities mandated with the financial system oversight.² The complexity of the overall setup creates conditions where coordination across two dimensions—horizontal coordination between government and agencies, and vertical coordination between levels (or tiers) of governance—becomes extremely challenging.

Operationally, the regulatory and supervisory practices at the sectoral level create preconditions for effective groupwide supervision, with a strong focus on bank dominated groups. Korea's group-wide supervision, which is viewed as supplementary to sector-level supervision, is implemented using sectoral laws. Hence, it is one system that has to be considered holistically. The post-crisis regulatory agenda has been translated to a predominantly rules-based system with regulatory requirements implemented broadly in line with international standards. As a result, however, the system misses a 'forward looking' character and hampers the ability of supervisors to proactively address buildup of risks.³ The remit of financial conglomerates supervision covers only groups dominated by banking business, which results in a significant component of risk that is not yet fully covered given the significance of nonbanking activities. Moreover, group-level

¹ The author of this note is David Lukáš Rozumek, senior IMF financial sector expert and member of the FSAP 2019 team led by Udaibir Das, as well as Tim P. Clark, MCM external expert, Timo Broszeit, MCM external expert and Tan Sri Ranjit Ajit Singh, MCM external expert. The analysis has benefitted from discussions with the staff of the BOK, FSC, FSS, the Korea FSAP team, and reviewers at the IMF.

² The FSC/FSS, the Bank of Korea (BoK) and the Korea Deposit Insurance Corporation (KDIC). For more details, see Appendix II.

³ Approaches like Pillar 2 or an ORSA are not fully adopted in supervisory practice. The tools used by supervisors do not have a preemptive effect and only ex-post follow up on identified risks and shortcomings.

supervisory approaches are not applied consistently across holding financial groups (HFG).⁴ The absence of a modern resolution and recovery framework increases costs for handling financial stress in complex groups. The prudential and supervisory regime needs to evolve to place greater emphasis on assessments of firms' risk management capabilities, with on-site examinations more targeted at key risks. Qualitative components of supervisory assessments could be strengthened.

A major gap in the mandate of conglomerate supervision is a lack of authority to regulate financial conglomerates which do not have a straightforward holding company structure. By law the FSC/FSS are tasked with supervision of groups with a clearly defined head—a financial holding company (FHC). However, nonholding financial groups with a mix of commercial and financial services firms—some of them systematically important—are not regulated on a group level, hence the authorities cannot assess and regulate risks emerging from the operations of their nonfinancial affiliates⁵ nor comprehensively supervise activities of their financial institutions. For a complete picture to support supervisory analysis and effective supervision, the authorities must have authority to understand the broader group of affiliates and obtain relevant information from non-financial affiliates where those may be a source of potential vulnerability to financial affiliates. Also, the authorities should ensure that a group's specific structure does not impede effective supervision, including authority to use their supervisory powers to designate a "head of group".⁶

In addition, a set of regulatory measures that provides strong incentives for these complex groups to streamline their structures should be developed and endorsed by legislators. It should primarily include the implementation of binding prudential framework for non-holding financial groups and disclosure, which are currently being considered by the FSC.⁷ A group level capital ratio for non-holding financial groups should reflect double/multiple gearing as well as group level contagion and concentration risk, considering the overall governance of the group with focus on its complexity and size (including a wider group). Requiring the reporting of detailed information about group structure would be an important upgrade of the legal framework which is being considered by the FSC, motivating groups to streamline their organization.

For all forms of financial conglomerates operating in Korea, the definition of the head of the financial conglomerate might be too prescriptive to effectively enforce group supervision across financial conglomerates. The precise definition⁸ can promote a strong consistency of application. However, in exceptional cases this inflexibility can undermine the effectiveness of the framework by creating gaps in its application. Additional quantitative and qualitative criteria describing the underlying logic of basic thresholds, applied together with the requirement of a

⁴ E.g. group level boards' accountability, group-level capital planning.

⁵ It does not mean that the FSC/FSS should regulate the activities of nonfinancial entities.

⁶ For holding financial groups, a head of the group is a financial holding company. In the case of banking or insurance groups, it is a respective bank or insurance corporation. However, in the case of nonholding financial groups, there is no certainty about a holding company, so a designated financial institution is considered to be a head of the group, with regulatory obligations similar to a financial holding company.

⁷ Recommendations #4 and #5.

⁸ These broad-based tools are only applicable to the banking sector and in some cases to investment firms.

group structure that does not impede effective supervision, could strengthen the current approach. At the same time, the FSC/FSS should better leverage its authority to designate a “head of a group” for all financial conglomerates.

Supervisory practice should leverage on the outcome of a restrictive regulatory framework for HFGs by applying a look through approach to the entire group and all affiliates, focusing on the quality of capital and risks’ dynamics.⁹ Strong regulations have helped to streamline the group structures of HFGs and to establish a solid system of group-level supervision, including the monitoring of intragroup transactions. By putting emphasis on developing a deep understanding of the context of the groups’ organization and structure, supervisors could further enhance their forward-looking and risk-oriented approaches. Multilayer analyses of conglomerate maps, which captures the relationships between the group structure, the quality of capital and risks’ dynamics within the groups, including for use in potential crisis situations, would significantly elevate supervisory understanding and outcomes. There can be specific challenges for group supervision at groups of financial institutions with official policy functions, as their complex structures serve a broad variety of goals, which can result in additional risks, that may be outside of the perimeter of financial supervision. Also, more supervisory attention should focus on climate risk and other emerging risks affecting groups across their structures.

Additional opportunities to enhance the effectiveness of supervision can be taken through greater use of key forward-looking practices, specifically by using periodic in-depth reviews of group level capital and liquidity management approaches, including their governance frameworks. Specific practices warranting such reviews could include credit risk management, the Internal Capital Adequacy Assessment Process (ICAAP) and capital planning, Internal Liquidity Adequacy Assessment Process (ILAAP) and liquidity planning and recovery planning, for banking groups. Specifically in insurance, the findings from the reviews of Own Risk and Solvency Assessment (ORSA) should be incorporated into the overall risk assessment, including systematic feedback in the form of a risk dialogue provided to the companies. Supervisory emphasis on forward-looking practices and techniques can also play an important role in promoting financial resiliency by making clear to boards and senior managers of financial holding companies that ensuring effective group-wide practices in these areas are important elements of their roles and responsibilities and that they will be assessed on their effectiveness in carrying out these responsibilities. These periodic assessments should factor into evaluations of board and senior management effectiveness as well as to Pillar 2 requirements imposed by supervisors.

To carry out comprehensive, group-wide supervision, the FSC/FSS needs to further leverage its position as an integrated supervisor that is well positioned to connect outcomes of forward-looking and in-depth approaches into a strong integrated framework of supervision for groups. The current approach to supervision of financial groups is primarily organized around supervision of legal entities, with a relatively small team of “group-level” supervisors. Given the systemic importance of these groups and that growth is being driven largely by non-bank activities, the authorities will need to continue to develop and implement more group-wide supervision

⁹ A similar approach has been applied in the proposals for the regulation of nonholding financial groups.

practices. There may be opportunities to enhance overall effectiveness of the FSC/FSS' supervision by either increasing total staffing levels for large financial conglomerates directly or rebalancing resource allocation across different parts of the framework.

Furthermore, given the plans of large Korean financial groups to continue overseas expansion, cross-border supervisory activities would benefit from enhanced international coordination and cooperation. The FSC/FSS perform examinations of foreign branches and subsidiaries of banks. Also, visiting programs and conferences are organized for foreign supervisors. Closer and intensified monitoring of overseas expansion, closer cooperation with host authorities at the working level, and setting up supervisory colleges is warranted. Also, despite the increasing strategic importance of the overseas activity of Korean banks and the significant share of foreign banks in the Korean system, little thought has been given to managing the failure of cross-border firms.

Table 1. Korea: Main Recommendations¹

Recommendation	*	**
<i>Preconditions for Effective Conglomerate Supervision</i>		
1. Strengthen effectiveness of supervision by redistribution of powers and responsibilities between the FSC and FSS, by greater delegation of budgetary, supervisory guidelines, and enforcement processes to the FSS, and the FSC assuming a role on strategy, financial legislation, and financial infrastructure. (¶125-32, pp 17-19; ¶135, p 20)	LT	H
2. Improve information flow and coordination across sectoral supervisors and build up capacity for coordinated oversight of both conduct and prudential supervision. (¶133, p 19; ¶120, 122, 125, pp 43-44)	ST	M
<i>Conglomerate Regulatory and Supervisory Framework</i>		
3. Enhance regulatory and supervisory powers of the FSC/FSS to all financial conglomerates, including “non-holding financial groups” by extending the legal framework, including to reach non-financial institutions of a wider-group, for the purpose of requiring data and information supporting the FSC/FSS’s core activities. (¶134, 36, p 20; ¶148, p 24)	MT	H
4. Expand the legally binding prudential requirements to cover all systemically important / significant financial conglomerates, including “non-holding financial groups”, considering the specificities of existing financial conglomerates. (¶152-55, pp 25-27)	MT	H
5. Enhance regulatory framework for all financial conglomerates by the requirement of a sufficiently transparent structure (including their disclosure) which would not impede effectiveness of actions taken in crisis situations, threatening the stability of financial institutions. (¶137, 20)	LT	H
6. To further promote resiliency at the largest groups, implement detailed regulations and increase supervisory focus on DSIBs’ group-level recovery planning and preparedness, reflecting a complexity of financial conglomerates. (¶151, p 25; ¶165, p 30, ¶116, p 42)	LT	H
7. Gradually enhance cross-border cooperation, including the consideration of establishing supervisory colleges for particular financial groups/institutions. Closely monitor overseas expansion of financial institutions. (¶167-169, p 54)	LT	M
8. FSC, FSS, BoK and KDIC should jointly assess the value of current regulatory reporting requirements in the context of efforts to monitor and assess risks to financial stability. Revise reporting requirements as deemed warranted. (¶162, p 30)	MT	H

Table 1. Korea: Main Recommendations (concluded)

Conglomerate Supervisory Practices		
9. Enhance the use the outcomes of the multilayer analyses and assessments of conglomerates' maps in a comprehensive risk based approach, addressing among others multiple gearing, excessive leverage, contagion risk, concentration risk, conflicts of interests, overall governance of the group, etc. (¶121, p 43)	MT	M
10. In applying the principle of prudential 'proportionality' ensure stronger requirements on governance, risk management, liquidity and capital, using all available supervisory tools, including ORSA and Pillar 2, and with increased supervisory intensity and enforcement for systemically important FHCs and specialized banks. (¶126-134, pp 44-45; ¶142, p 48; ¶159-160, pp 51-52)	ST	H
11. Strengthen corporate governance requirements with higher levels of supervisory engagement with the boards and senior managers regarding their responsibility to oversee the execution of the approved risk-management framework and internal controls practices on an enterprise and a group wide level, including enforcement of their accountabilities and supported by strong accounting and auditing standards. (¶39, p 21; ¶58-61, pp 27-29; ¶111, p 41; ¶130-135, pp 46-47; ¶160, p 51; ¶165, p 53)	MT	H
Supporting Actions		
12. Complete the introduction of a fully risk-based solvency regime, provide a stronger focus on capital adequacy, and ensure a prudent and proportional implementation of Korea Insurance Capital Standard (K-ICS). (¶88, p 35)	ST	H
13. Intensify supervision and review the role of specialized banks ensuring that those undertaking commercial banking activities strictly conform with all prudential requirements applicable to nationwide banks. (¶71, p 31; ¶118, pp 42-43)	ST	H
14. Develop a strategic supervisory plan for mutual saving banks and mutual credit cooperatives (MCCs) and encourage further consolidation, to help restore financial soundness. (¶74-77, pp 32-33)	MT	H
15. Grant operational powers to the supervisor to restrict the development or sale of financial products, activities and practices causing significant investor, consumer, and or depositor protection concerns. (¶161-166, pp 52-52)	ST	H
16. Develop interagency cooperation framework led by the FSC/FSS/BOK on climate risk to discuss emerging risks and propose policy actions across the financial system. (¶171, p 55)	ST	H

* Timing: C: continuous; I: immediate (<1 year); ST: short term (1–2 years); MT: medium term (3–5 years); LT: long term (>5 years)
 ** Priority: H: High; M: Medium; L: Low
 1/ Complemented by supporting measures listed in Appendix I. – Supporting Measures.

INTRODUCTION

A. Scope and Approach

1. This note was prepared in the context of the FSAP missions to Korea from August 20 to September 6, 2019 and from December 3 to December 19, 2019. It presents the mission's findings and recommendations on topics of financial conglomerate supervision, which steers the sectoral elements of bank, insurance and capital market supervision. Korea's group-wide supervision, is complementary to sectoral supervision, which both together forms one system that has to be considered holistically. The topics were selected primarily according to the findings and observations following the Joint Forum Principles for Financial Conglomerate Supervision of 2012 (PFCS), which was used as a basic reference. Also, several cross-cutting topics of (i) corporate governance, (ii) risk management, (iii) liquidity and capital assessment process, (iv) organization of supervision, (v) cross-border cooperation, (vi) climate risk, relevant for supervision of all sectors were explored, to review the quality and consistency across sectoral practices, and to assesses how they contribute to the effectiveness of conglomerates supervision.¹⁰ Additionally, consumer protection and conduct risk were discussed and assessed. For the sectoral perspective, the relevant international standards were used as a benchmark.

2. To support this note, the FSC/FSS prepared its self-assessment of PFCS, an update to the self-assessment of the BCP of 2013, the ICP of 2018, the selected IOSCO Objectives and Principles for Securities Supervision of 2017 (IOP) and provided answers to long questionnaires on specific qualitative and quantitative topics. The mission had access to supervisory documents and files, staff and systems, and held extensive meetings with the FSC/FSS staff. The mission also met auditing firms, industry members, and other stakeholders. The mission enjoyed full cooperation from the authorities. The mission wishes to acknowledge the time and effort expended by the FSC/FSS staff and thank them for their cooperation and hospitality. We also thank other parties for their time and insights.

3. The mission's findings and recommendations are to be understood in the context of the Korean authorities' very solid standards, and the increasing global and national importance of the financial system under the FSC/FSS's supervision. Korean financial authorities are committed to continuously improving standards of regulation and supervision. The Korean regulatory framework embodies strict prudential rules, and establishes a set of prudent limits and restrictions for financial conglomerates with a bank, that seem to be sufficiently robust. The authorities are aware of complex issues of conglomerates supervision, given their role in the economy and rather complicated structures in some cases. The current market conditions provide opportunities to nonbank financial intermediaries which influences the business development focus of financial groups. The Korean Government supports strategic goals of the industry to contribute to the growth of Small and medium enterprises (SMEs) in new technologies and to expand to new

¹⁰ The approach is illustrated on figures in Appendix VI. – Models of Organization of Sectoral Supervisory Activities.

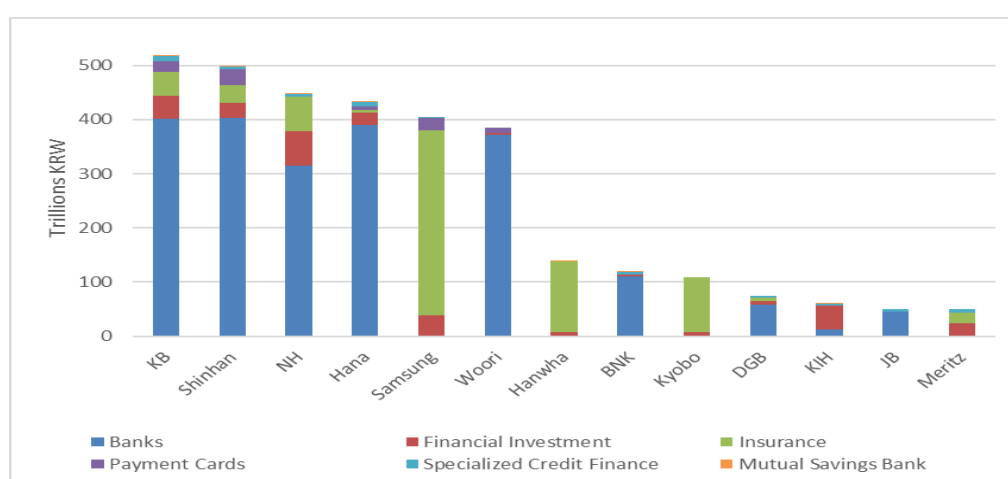
overseas markets. These challenges provide the basis to the strong commitment of Authorities to continuously strengthen the supervisory and regulatory framework.

B. Market Landscape

4. Financial conglomerates have a significant position in the financial system.¹¹ Some of them have a holding company structure, while other groups are typically “mixed activities financial conglomerates” without a clear holding company structure. The FSC/FSS define these groups as “non-holding financial groups”.

5. The overall number of financial conglomerates—meeting the definition of the PFCS¹²—is 44.¹³ Banking groups are represented by 13 conglomerates, with assets amounting 90.5 percent the total assets of the banking system. Banking groups emerged as a response to the effort to split core banking activities from other financial services, concentrated in separate legal entities, where risks related to their businesses could be ringfenced from banks by regulating intragroup exposures. There is one regulated as an insurance group (Meritz), and 4 other financial conglomerates with predominant activities in financial services. Mixed groups are comprised by 26 conglomerates, some of them critically important for Korean economy, mostly for their activities in areas other than financial services.¹⁴

Figure 1. Korea: Largest Financial Conglomerates: Assets Structure¹



Source: FSS

Note: ¹Agragated data from financial statements of major financial subsidiaries

¹¹ As of December 2018, there were 9 holding financial groups with total assets of 2.068 trillion won, and 30 non-holding financial groups with total assets amounting 1,179 trillion won. In 2019, one more financial conglomerate was recognized as a holding financial group.

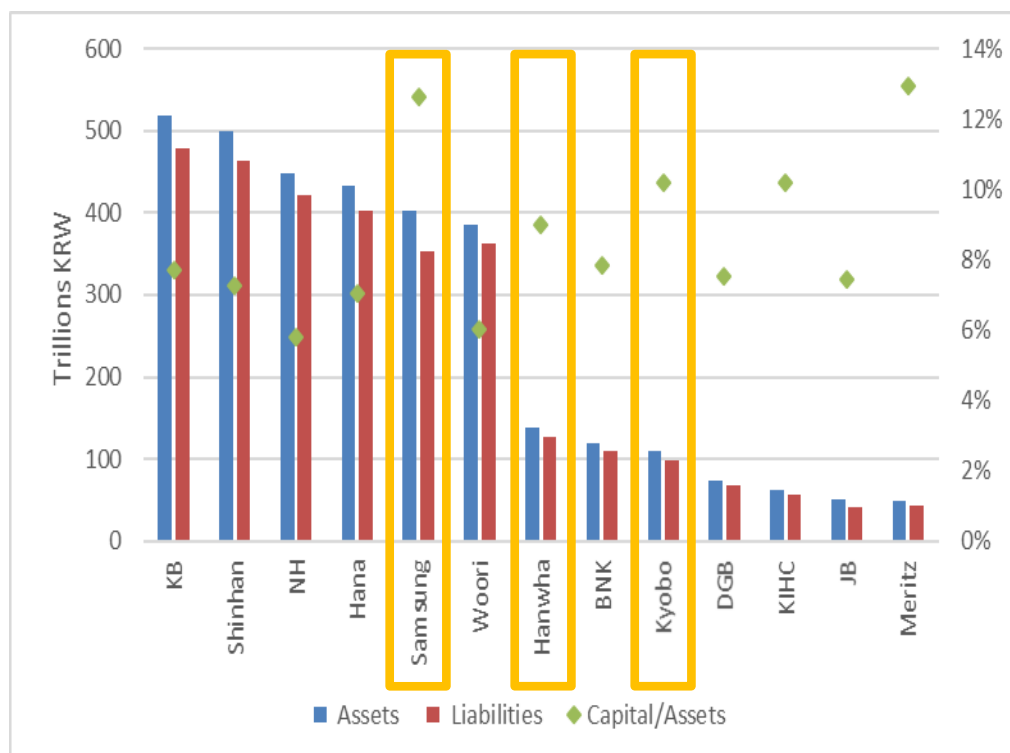
¹² Groups of companies under common control or dominant influence, including any FHC, which conduct material finance activities in at least two of the regulated banking, securities or insurance sectors.

¹³ The asset structure of the largest financial conglomerates is shown in Figure 1.

¹⁴ For a complete list of financial conglomerates see Appendix VIII. – Overview of Financial Conglomerates (2019).

6. Under full-fledged conglomerates supervision, there are 10 holding financial groups (HFGs),¹⁵ regulated in all relevant areas recognized by international standards. The HFGs have steadily increased their market share in total financial sector assets over last ten years, as their total assets have more than doubled, exceeding 2,000 trillion won.¹⁶ The number of HFGs has doubled in the same period of time. HFGs' assets relatively to the overall assets comprise 42 percent of the aggregate assets of the financial sector. Although HFGs are predominantly engaged in the banking business, their attention is turning to other financial services, which have made up a substantial share of HFG growth in recent years, as competition in banking is increasing and opportunities are narrowing down.

Figure 2. Korea: Regulated Financial Conglomerates (Holding Groups) and 3 Largest (Unregulated) Nonholding Groups¹



Source: FSS

Notes: ¹Agragated data from financial statements of major financial subsidiaries

Nonholding Financial Groups

¹⁵ Led by FHC, which meets these criteria: i) it shall control at least 1 financial institution; ii) Its total assets shall be greater than or equal to 500 billion won; iii) the total amount of stock values of its subsidiaries shall exceed 50 percent of the total amount of its assets.

¹⁶ The asset size of individual HFGs versus the largest non-holding financial group is captured by Figure 2.

7. Non-holding financial groups (NFGs) operate with the overall assets of 1,179 trillion won, as of December 2018. These financial conglomerates do not have a clearly defined lead company and their structures are often rather complex. They do not involve a bank, as banks cannot be part of mixed financial conglomerates, but in some cases, they conduct similar activities through other deposit institutions (ODI). Some non-holding financial groups are significant by their systemic importance.

8. In total, there are 5,511 financial entities supervised by the FSC/FSS, ranging from the thousands of small credit cooperatives and finance companies to the 6 systemically important financial holding companies engaged in banking, insurance and securities businesses. FSS supervision is organized by sector and size/type of institution. There are separate departments for large banks, mutual savings banks (MSBs) and mutual credit cooperatives (MCCs) and differing approaches to supervision for the smaller firms.

9. Of the 19 commercial and specialized banks in Korea, 14 are operating under bank holding companies, which have a total of approximately 275 subsidiaries. The financial companies under the bank holding companies operate across a broad cross-section of the financial sector, with key subsidiaries engaged in insurance, capital markets and asset management businesses.

10. The 19 domestic banks consist of 6 commercial banks (4 Korean and 2 foreign-owned 'nationwide banks'), 6 regional banks, 2 internet-only banks and 5 specialized banks. The quality of capital in the domestic banks is relatively strong, with 82 percent of total capital in the form of Common Equity Tier 1 (CET1), 4 percent of Additional Tier 1 (AT1) capital, and 14.0 percent of tier 2 capital. Specialized 'policy' banks are majority owned by the government and Standard Chartered and Citibank, the largest foreign banking organizations own the two foreign owned banks.

11. Korea has a quite broad range of other deposit taking institutions, including MSBs and MCCs. MSBs were first chartered in 1972 as thrift institutions designed to serve low-income individuals. This was part of the efforts to integrate private lenders into the institutionalized financial system. As local financial institutions, their function is still to provide low-income individuals and small- and mid-sized businesses with access to financial services. MCCs are voluntary, non-for-profit organizations set up by groups of entities having shared (community) interests. They are established to promote the financial well-being of their members through a cycle of mutual assistance among themselves, in order to contribute to the development of their local economy.

12. The assets of MSBs and MCCs amounts almost 20 percent of total deposit taking institutions' assets, facing multiple regulatory regimes depending on the segment. There are 79 MSBs, with total assets of roughly 70 trillion Korean Won (KRW) (accounting for 2 percent of the total assets of the deposit taking institutions) and the 3,544 MCCs with a total of 17.1 million members and assets of 670 trillion KRW operating in Korea. The sector of MSBs went through restructuring, between 2011 and 2014. Since then, MSBs have shown an upward trend in assets and profitability. Also, the MCCs has considerably grown in total assets in recent years.

13. A total of 54 insurance undertakings was active as of end-2018, two less than five years earlier. The sector comprises 24 life and 20 non-life companies, as well as ten reinsurers, all supervised and regulated by the FSC/FSS. Local firms dominate the industry, with a market share in the life sector of more than 80 percent, and of 98 percent in non-life. Both the life and non-life insurance sectors are highly concentrated, with three firms each accounting for over half of total assets. As the market is becoming more saturated, mergers and acquisitions have been common recently, driven both by domestic and foreign buyers. In parallel, however, some foreign life companies have been withdrawing from the Korean market recently. The Korean market is characterized by a very high number of insurance intermediaries—more than 400,000 insurance brokers and another 31,500 agents dominate the distribution channel. The bancassurance market is well developed and 50 percent of new business in life is sold via banks. However, the Insurance Business Act (IBA) limits a bank's sales of insurance from the same insurer to 25 percent of its total bancassurance sales.

14. Insurers managed KRW 1,011.7 trillion as of end-2018, corresponding to around two thirds of GDP. Three quarters are managed by life companies, with the remainder managed by non-life sector which, in international comparison, is relatively large due to the sizable share of long-term business. Assets have increased by 65 percent since end-2012. The asset allocation is dominated by large bond holdings (48 percent), but insurers also have significant loan exposures (18 percent).

15. The asset management industry comprises of both public and private funds markets. As of July 2019, the total assets under management by registered asset managers was around KRW 1,093 trillion. There has been a gradual trend observed over the past 5 years of a significant increase in the private funds' markets and a greater allocation towards alternative investments as well as foreign investments by Korean institutions and individuals. The Assets Under Management (AUM) has increased from a figure of KRW 685 trillion in 2014 to KRW 1,093.8 trillion in June 2019, an increase of 75 percent. There has also been an increase in the number of asset managers from 86 to 260 over the same period with the increase in numbers coming mainly from new private fund managers, particularly hedge fund managers.

16. Securities companies, particularly, the larger ones are generally sound despite the rather weak performance in the equity market and thin margins on equity brokerage. The regulators have facilitated an expansion of services for securities firms and much of their revenue generation is now through their corporate finance business, fixed income trading as well as their real estate arms. There is also a stated objective by the FSC to support creation of large investment banks which are defined as those with equity capital above KRW10 trillion. In the securities industry there are currently 22 out of 55 brokerages that are foreign owned which is 40 percent of total firms but despite their large number, foreign securities firms accounted for just around 10 percent of the industry's total workforce (eight percent) and paid-up capital (11 percent). Korean securities firms are also looking increasingly at establishing a presence in foreign markets, specifically there is a strong push into ASEAN markets particularly into Vietnam where five out of the top 10 Korean

securities firms have entered the ASEAN country to diversify their business portfolios as part of their efforts to overcome Korea's "saturated" financial market.

C. Institutional Framework

17. Korea uses an integrated financial supervision model, with the FSC/FSS as Korea's integrated financial supervisory authority.¹⁷ The FSS is mandated with daily tasks of supervision and operates under the guidance of the FSC which is a primary regulator and decision maker. The FSC is part of the Government and has a leading role in the supervision budgetary process. For regulation and supervision of other deposit taking institutions, the FSC/FSS's roles are complemented by several other authorities.¹⁸

18. The FSC as a lead regulator for the financial system assumes the primary responsibility for rulemaking and licensing, major enforcement decisions, and the government's financial market policy. As part of its regulatory mandate, the FSC deliberates and decides on policy matters directly pertaining to the supervision of financial institutions and the securities and futures markets. The measures preventing conflict of interest of the FSC's officers have been implemented. They are barred from holding any political position or engaging in any commercial activity during their tenure. The nine commissioners¹⁹ are also barred from participating in the resolution of matters that may raise conflicts of interest.

19. The FSS examines and supervises financial institutions to ensure they comply with prudential rules and regulations and act honestly and fairly towards consumers and investors. The FSS performs bank, insurance and capital market prudential supervision and takes on a range of initiatives to protect investors and consumers from malpractices of financial firms. The FSS also performs administrative functions in support of the rulemaking and licensing activities of the FSC. The FSS is led by the Governor, four deputy governors (or less), and nine assistant governors (or less).²⁰

20. By law the FSC/FSS are tasked with regulation and supervision of financial conglomerates, except of non-holding financial groups. Under conglomerates supervision, the FSC/FSS currently are responsible for HFGs, regulated in all relevant areas recognized by

¹⁷ See Appendix II. – Map of Financial Sector Oversight Structure.

¹⁸ For a full description of institutional mandates in the financial system regulation and supervision see Appendix III. – Institutional Architecture of Deposit Taking Institutions' supervision.

¹⁹ The FSC Chairman; Vice Chairman; two standing commissioners (appointed at the recommendation of the Chairman); four ex-officio positions held by the Vice Minister of Economy and Finance, Governor of the FSS, Deputy Governor of the BoK and the President of the KDIC; and one non-standing commissioner who is appointed with the recommendation of the Chairman of the Korea Chamber of Commerce and Industry. The FSC Chairman is appointed by the President with the recommendation of the Prime Minister. The Vice Chairman is appointed by the President with the recommendation of the Chairman of the FSC and concurrently holds chairmanship of the SFC within the FSC. As the government regulatory authority, the FSC is staffed by career civil servants.

²⁰ The Governor of the FSS shall be appointed by the President on the recommendation of the Chairperson of the FSC. A deputy governor of the FSS shall be appointed by the FSC on the recommendation of the Governor, and an assistant governor of the FSS shall be appointed by the Governor.

international standards, except of the recovery and resolution preparedness framework.²¹ The Fair-Trade Commission (FTC) regulates other large Korean groups under antitrust and market concentration objectives.

21. The FSC/FSS share responsibility for regulation and supervision of ODIs with several authorities. The FSC is responsible for chartering and licensing MSBs and setting prudential rules. MSBs are under supervision of the FSS. For MCCs, regulations differ depending on the segment. Credit unions are chartered and licensed by the FSC and are subject to the prudential rules set by the FSC, primarily supervised by the FSS – sharing the responsibility with the National Federation of Credit Unions. Agricultural, fisheries, and forestry cooperatives are chartered and licensed by different authorities depending on their purpose of establishment. They are regulated by the FSC and FSS and inspected by their national federations. For Community Credit Cooperatives, the Ministry of the interior and Safety carries out the task of supervision, together with the National Federation of Community Credit Cooperatives, in consultation with the FSC. The Ministry can also request the inspection of the FSS.²²

22. The Securities and Futures Commission (SFC) is a regulatory commission integrated within the FSC structure that performs the oversight of the securities and futures markets. It consists of five members who are appointed by the President for a renewable three-year term.²³ The principal role of the SFC is to direct investigations of market misconduct and abuse such as insider trading and market manipulation in the securities and futures markets and to establish accounting and audit standards. In addition, the SFC conducts preliminary review of regulatory matters relating to the securities and futures markets that are to be deliberated by the FSC.

23. As Korea's central bank, the BoK is responsible for the country's monetary and credit policies,²⁴ payment systems operations, is the lender of last resort, and its top decision-making body is the Monetary Policy Board.²⁵ The BoK has its own plan of examinations. The BoK also has the authority to request the FSS to conduct an examination of a specific financial institution or to conduct a joint examination with the participation of specialists from the BoK. This occurs, if

²¹ Authorities lack a proper legal framework to guide the resolvability of groups and the issue is neither addressed in their supervisory approaches.

²² See Appendix III. – Institutional Architecture of Deposit Taking Institutions Supervision.

²³ The vice chairman of the FSC concurrently holds the position of the chairman of the SFC. The standing commissioner and three non-standing commissioners are appointed with the recommendation of the chairman of the FSC.

²⁴ The monetary and credit policies of the BoK shall be carried out in harmony with the economic policy of the Government insofar as this does not detract from price stability.

²⁵ The Monetary Policy Board shall be composed of the following seven members: the Governor; the Senior Deputy Governor of the BoK; one member recommended by the Minister of Strategy and Finance; one member recommended by the Governor of the BoK; one member recommended by the Chairman of the FSC; one member recommended by the Chairman of the Korea Chamber of Commerce and Industry; and one member recommended by the Chairman of the Korea Federation of Banks, an incorporated association. The Governor shall be appointed by the President following deliberation by the State Council and a Personnel Hearing in the National Assembly. The Governor may appoint the Senior Deputy Governor and the Deputy Governors.

deemed, necessary for implementing monetary policies and therefore the BoK can, depending on the circumstances, be involved in the supervision of regulated entities in the financial system.

24. The KDIC manages deposit insurance funds and runs resolution programs of insolvent institutions, including deposit payouts and financial assistance. Similarly as the BoK, the KDIC can request the FSS to conduct an examination or can initiate a joint examination of financial institutions within its mandate. Also, KDIC has its own supervisory program, including its own version of stress tests (annual simulation exercises focused on re-running historical failures). The KDIC's main policy making body is the Commission which consists of 7 members.²⁶

MAIN FINDINGS AND RECOMMENDATIONS

A. Institutional Framework

25. The overall setup of four agencies (the FSC and the FSS, the BoK, and the KDIC) as the regulators and supervisors with different and overlapping responsibilities and authorities is rather complex, including cross-memberships in their boards. There are protocols for cooperation, joint consultative bodies and working groups. The cooperation is primarily facilitated through regular meetings of key stakeholders in the supervisory process. Although these arrangements seem to be quite robust, the efficiency of the overall setup can be a challenge. The enforcement actions or the budgetary process can be good examples, as well as complex coordination of on-site examinations. Although Authorities claim that the purpose of these examination varies, their substance is largely similar.

26. The FSC/FSS should ensure that the safety and soundness of the Korean financial system is a top and clearly stated priority in their mission and objectives. By mixing the focus on supervision into the stated mission of enhancing competitiveness, promoting Korea as a global financial center and supporting domestic financial institutions in globalizing their business operations, for example, the FSC risks undermining confidence in the independence of supervisory assessments and supervisory effectiveness. Safety and soundness of the financial system should not come to be perceived as a second order or a similar level consideration with these broader, business development goals. Furthermore, a possibility of potentially conflicting goals should be minimized. Safety and soundness supervision, coupled with rapid action requiring firms to address material weaknesses in any of these areas, will enhance confidence in the financial institutions and is a critical underpinning to a strong and competitive financial system.

27. The flexibility of the allocation of the supervision budget is an important feature of effective supervision, which can be quite difficult to achieve within the current arrangements.

²⁶ The president of the Corporation; the Vice Chairman of the FSC; the Vice Minister of Strategy and Finance; The Vice Governor of the BoK; one member commissioned by the FSC, and 2 members commissioned by the FSC on the recommendation of the Minister of Strategy and Finance and the Governor of the BoK. The president shall be appointed and dismissed by the President of Korea upon the recommendation of the Chairman of the FSC. The vice president shall be appointed and dismissed by the FSC upon the recommendation of the president of the Corporation.

The FSC defines the budget of the FSS with relatively great level of detail, including determining the number of headcounts and the distribution of paygrades.²⁷ The role of the FSS in the process is rather limited. Primarily, it provides technical information, filling the structure defined by guidelines of the FSC.²⁸ In this sense, the budgetary process is quite rigid, and thus not necessarily conducive to accommodate the changing needs of supervision. On one hand, supervision is a public service and it is quite understandable that the Government wants to keep its cost under scrutiny. On the other hand, supervision is funded through the industry fees to deliver (among others) the best possible quality of this service. The cost efficiency of supervisory processes can be achieved through a wide array of tools that would provide supervision with more flexibility in a specific allocation of its budget—but still maintaining a high level of prudence. The example of such tools can be precise budgetary rules complemented by guidance based on principles, delegating concrete decisions about the budget to supervision (the FSS), in combination with a strong oversight function of the FSC and the industry over spending (including regular financial audits).

28. The FSC/FSS should consider the possibility of maintaining any surplus of the FSS budget as a reserve that can be built over time and used when needed. It could be in particular important in times when the markets may not be as active—thus impacting the revenue base—but the demands for supervisory work continue to remain the same or even higher as stressed market conditions usually require greater intensity of supervision.

29. The FSC/FSS enforcement process would benefit from a rearrangement, so it could better address the gravity of supervisory findings and provide a strong underpinning to supervisory actions. The FSS has created a solid structure of the enforcement process, within its mandate, including the involvement of a council composed by internal and external members, reviewing proposals of enforcement actions. This council—as an advisory body—can positively contribute to the quality of decision making by independent views based on high erudition of its members. However, the participation of external members in an early stage of the decision making process can discourage examiners in proposing bold supervisory actions. For that reason, external members usually contribute in later stages, e.g. by advising to the board of appeal. The effectiveness of enforcement would gain from a greater distinction of the roles of the FSC and the FSS in the enforcement process. It is well understood that a formal action needs to be adopted by the FSC. However, the FSS could play a greater role in defining the substance of the enforcement decisions, later endorsed by the FSC. The FSC would still control the process of enforcement actions, but its

²⁷ The FSS is funded primarily from fees collected from financial institutions and securities issuers as well as a small appropriation from the BoK and this makes up most of the FSS's operating budget. The relative share of fees to be contributed by the regulated financial institutions is determined annually by the FSC on the basis of the total amount of the liabilities of the regulated financial institutions at the end of the previous fiscal year, subject to certain restrictions. The relative share to be collected from securities issuers is also determined by the FSC on the basis of the total amount of securities issued.

²⁸ The total operating budget with of the FSS is KRW350 billion for an overall staff strength of about 2000 personnel. The supervision fees from financial institutions make up approximately 80 percent of the total revenues collected, with the securities registration fees and contributions from the BoK each accounting for 17 percent and 2.7 percent of the total. Any surplus from the total revenue collected over the operating expenses are returned to the industry players every year.

discretion in decision making would be limited, substantially relying on the FSS input and focusing on the process efficiency.

30. Furthermore, the FSC/FSS have no legal foothold to impose legally binding actions on Nonholding Financial Groups (NFGs), which can undermine the overall effectiveness of supervision. the FSC's/FSS's legal mandate towards NFGs needs to be expanded.²⁹

31. The heads of the FSC/FSS and the SFC are appointed for a three years term, which provides quite narrow time frame for the definition and execution of a long-term strategy. In addition, the three most recent heads of the FSC and the FSS resigned before the end of their mandate. The overall arrangements do not seem to be supportive to a strong and consistent leadership of supervision. The term defined by law should be extended, to allow implementation of long-term goals. The independence safeguards provided by law need to be strengthened to foster the position of the heads, their selection process is recommended to be modified to better accommodate qualification requirements.

32. The system of regulation primarily consists of binding rules, with limited range of regulatory products providing guidance based on principles. The principle based guidelines could better address a wide variety of issues and/or promote good practices. This form of regulation is perhaps more conducive to the spirit of the post-crisis reforms and should be considered by authorities.

33. The FSC/FSS have started addressing the need to apply a cross-sectoral perspective in the supervision of FHGs by creating cross-sectoral divisions dedicated to group supervision.³⁰ These divisions have broader mandates to allow an efficient and systematic response to group-wide risks. To underpin the importance of the new approach, the FSS's cross-sectoral divisions report directly to First Senior Deputy Governor and to Senior Deputy Governors, respectively. The new governance structure has proved to be efficient in the first cross-sectoral examination. In order to development this agenda further, the FSS needs to build on its capacity in the area, by increasing the number of staff. The FSC positioned the Financial Group Regulation Bureau high in its hierarchy and dedicates increased attention to the agenda, which leads to gradual improvements of the regulatory framework. The authorities also formed a joint consultative body that is comprised of relevant representatives to facilitate an efficient supervisory cooperation in the financial conglomerates field.

34. The FSC/FSS do not have powers to supervise conglomerates without a clearly defined holding structure on a group level. The Financial Holding Companies Act (FHCA) defines the frameworks relating to supervision of financial conglomerates as "ensuring the sound management of the financial conglomerates". However, this applies only to HFGs. Supervision of NFGs is currently

²⁹ The topic is further elaborated in the following Chapters.

³⁰ See Appendix IV. – Organization Chart of FSC and Appendix V. – Organization Chart of FSS with Focus on Group/Cross-sectoral Supervision.

exercised on the basis of FSC recommendations which are not legally binding. The FSC/FSS needs a strong legal mandate to supervise these groups and to impose group level regulation.

35. The complexity of the Korean system of mutual credit cooperatives (MCCs), which is a combination of a comprehensive setup of sectoral silos (agriculture, forestry, etc.) serving broader needs of communities and a multi-tier system of financial supervisors, can create challenges in prompt and well targeted actions. Depending on the purpose of their establishment, MCCs are chartered by different ministries and authorities, supervised by their federations and the FSS. The primary prudential regulator is the FSC, except for community credit cooperatives where the Ministry of the Interior and Safety is entrusted with this role. This quite complex architecture can face some pressures in the changing market environment, as it can fail to address new challenges swiftly. This can be also substantiated by partially conflicting goals of the authorities. For this reason, the FSC should strengthen its steering role in supervision of these financial institutions by developing a strategic supervisory plan, (i) underpinning further actions to strengthen the stability of these institutions, and (ii) supporting its leading role as a prudential regulator. This plan should include the alignment of prudential standards and the institutional powers in prudential regulation across these institutions.

B. Regulatory Frameworks

Summary

36. Supervision lacks a legal mandate to regulate financial conglomerates which do not have a straightforward holding structure. By law the FSC/FSS are tasked with supervision of groups with a clearly defined head—a financial holding company. However, other financial groups—some of them systematically important—are not regulated on a group level, hence the authorities cannot assess and regulate risks emerging from the operations of their nonfinancial parts nor comprehensively supervise activities of their financial institutions. For a complete picture of supervisory analyses, the authorities must be mandated to reach a wider group with their information requests.

37. A set of regulatory measures incentivizing groups to streamline their group structures should be developed and the FSC/FSS's mandate expanded. The FSC/FSS should also supervise financial conglomerates without a straightforward holding structure. A prudential framework for these “non-holding financial groups”, which is currently considered by the FSC, should be developed. Information disclosure of the group's ownership structure would be an important upgrade. Group structures that do not impede effective supervision, recovery and resolution should be required. The supervisory authorities should have discretionary powers when designating heads of financial conglomerates (holding companies) to ensure that potentially systemic groups are under regulatory purview.

38. Korea has a solid, rules-based regulatory regime largely in line with international standards, which through regulation of individual sectors effectively supports the financial conglomerates framework. While capital requirements are in place at the holding company level,

liquidity requirements currently apply only at banks and other financial subsidiaries. The lack of requirements at the holding company level is an important gap that should be addressed given the growth of non-banking activities in DSIB banking groups. In some areas, such as concentration and large exposure restrictions, the authorities are piloting some thresholds but are still considering the best approach for the Korean banking system. In insurance, implementation of the new K-ICS and IFRS 17 are important reforms. For capital markets, there is a need to accelerate the implementation of the IOSCO MMF Recommendations.

39. In terms of corporate governance requirements across financial institutions and groups, accountability of boards with respect both to meeting expectations for responsibilities related to fit and proper assessments and running the firm in a safe and sound manner is a major weakness. The FSC/FSS do not have the legal authority to evaluate board members and senior officers against specific qualification requirements and approve them for the positions; reviews in the context of regular supervisory assessments cannot fully replace these approvals as they miss the opportunity to formulate a concrete content of the accountability of board members and senior officers to supervisors at the beginning of their mandates. Additionally, on a group level, assessing responsibility of boards and senior managers for an issue that occurred on the level of a subsidiary can pose a challenge.

40. The authorities need to accelerate the implementation of the reforms to address risks of accounting and expand auditors' obligations beyond the audits of financial statements. The planned financial statements review system should be put in place and linked with the audit and accounting oversight efforts so that there is a comprehensive assessment that can be made. Additional assignments to auditors can include the accuracy of regulatory reporting, or the effectiveness of internal control processes, including risk management, and systems—on enterprise and group level. The auditors should be required to report major flaws and failures to the FSC/FSS.

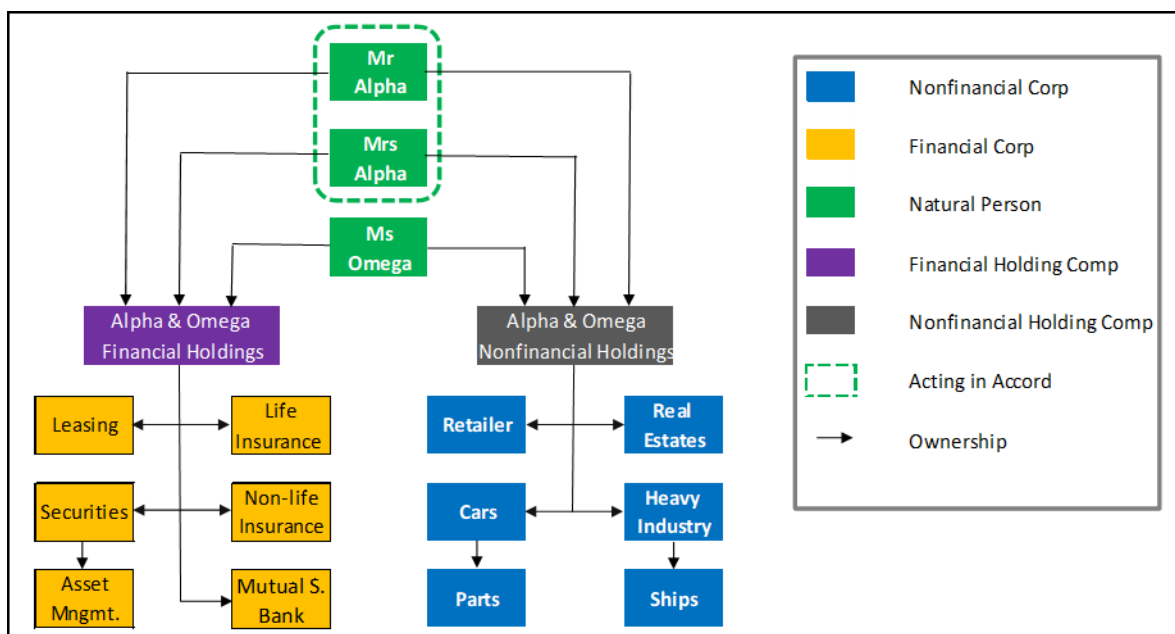
Financial Conglomerates

41. There are two regulatory frameworks established for supervision of financial conglomerates for two different types of group structures.³¹ The FHCA provides a legal basis for supervision of the groups meeting defined characteristics of a holding structure—HFGs. The Consultation Papers on the Supervision of Financial Conglomerates (CPFC), nonbinding recommendations, set standards for supervision of NFGs, groups with a complex structure, not headed by a holding company.

³¹ The assessment is based on the regulation which was in force by June 30, 2019.

42. HFGs face a restrictive regulatory framework, determining less complex group structures, specificities in overall governance and a strong role of compliance based supervisory approaches. The aim is to prevent industrial conglomerates from establishing a bank as the treasury within the group. Law establishes a system of limits and restrictions to ring-fence banking operations and associated risks. First of all, a bank cannot be a member of a mixed conglomerate, but only of HFG, composed solely of financial institutions. Only financial companies or companies pursuing financial-related business are allowed to be incorporated into the group as the HFG's subsidiaries, and only financial companies in related business can be incorporated as the holding company's second-tier or third-tier subsidiaries.³² Regulation implies simple and hierarchic structures of HFGs, consisting of holding companies and two tiers of subsidiaries. The clarity of structures is also encouraged by supervisors with their close focus on compliance with these requirements.⁸ Regulations regarding intra-group transactions and investments are particularly strict for HFGs and include: prohibition of the investment among subsidiaries, restriction on the amount of credit granting among subsidiaries, and prohibition of the subsidiary's granting credit to as well as stock investment in the holding company.

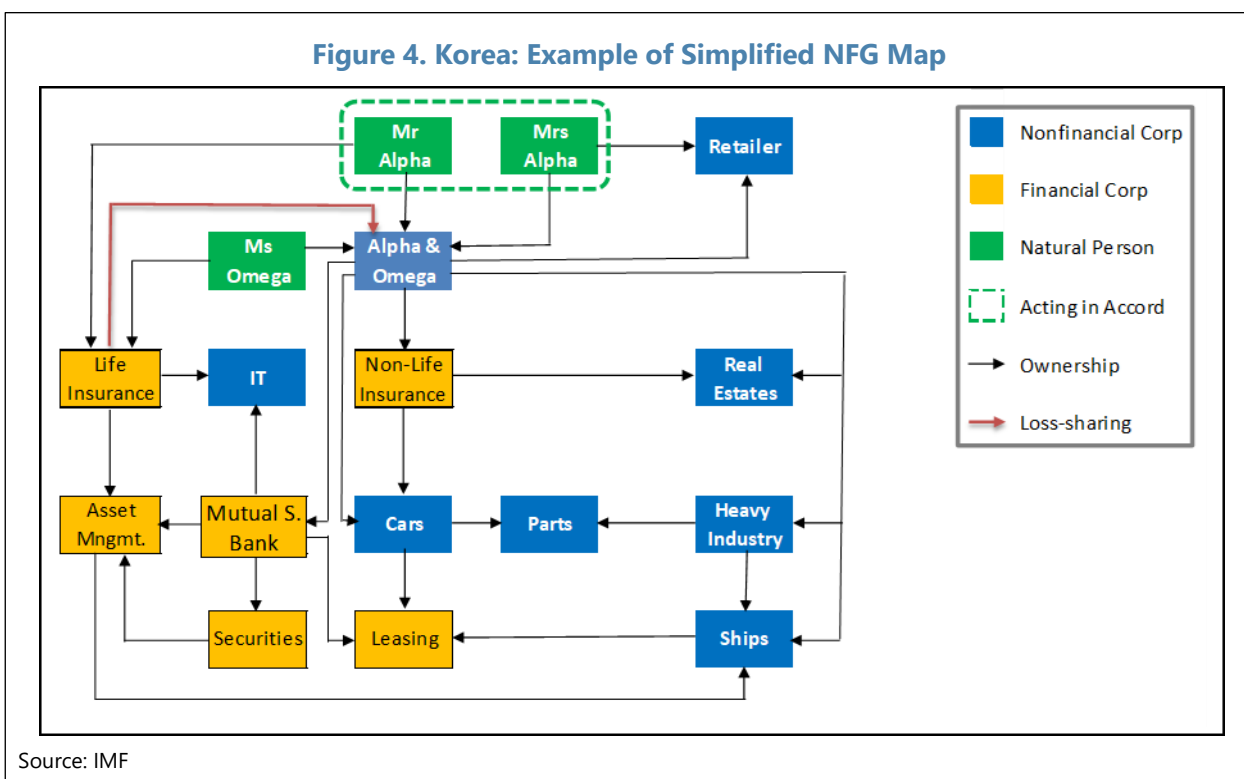
Figure 3. Korea: Example of Simplified HFG Map



Source: IMF

³² The minority holdings are limited by additional capital requirements. The rules specifically apply to bank holding companies of which the amount of investment in non-financial affiliates exceeds 15 percent of the total amount of the holding company's investment. The larger number of the following that exceeds the given limits, is added to the RWAs (with a weight of 1,250 percent): 1) excess of investment in an individual non-financial company that exceeds 15 percent of the bank holding company's equity; 2) excess of the total summation of investment in non-financial companies that exceeds 60 percent of the bank holding company's equity.

43. A legal framework for NFGs on a group-wide basis is under gradual development, aiming to develop effective approaches that bring more transparency to these groups. These groups are defined as financial conglomerates by international standards, but application of the principles is challenging given complex structures of these groups and the lack of a legally binding regulatory framework.³³ The legislators proposed two bills largely inspired by the CPFC to the Parliament, where they have been pending for more than one year.³⁴ So currently, there does not exist a process by which the financial authorities can either approve of, or control, the change in the group structure for NFGs. The mentioned bills suggest provisions that could enable the financial authorities to exert sufficient influence over its affiliates, the level of which is similar to that of HFGs.



44. Korea's group-wide supervision forms together with sectoral supervision one system that has to be considered holistically. These sectoral laws define prudential requirements for consolidated supervision of HFGs. They include corporate governance rules, capital and liquidity rules, and risk management requirements. It means that sectoral laws do not only provide context to the group regulatory framework, but they are its inherent and inseparable component.

³³ The complexity of NFGs is demonstrated on Figure 4 – Example of Simplified NFG Map. This structure makes supervision of group-wide risks (including potential contagion risk) extremely challenging, as it is very difficult to identify all consequences of a group's organization for the stability of financial institutions. Also, the application of regulatory and supervisory tools faces major obstacles, as all relations within a group (and group activities) are intertwined. In contrast, Appendix VII. – Illustrative Examples of Financial Groups, suggests how the same group of enterprises could be organized in a more transparent way, benefiting from a holding company structure.

³⁴ Relevant bills have been proposed in June and November 2018.

45. The legal definition of HFG can prevent group-wide supervision to reach relevant areas beyond the regulatory perimeter.³⁵ The definition is based on precise criteria not allowing any interpretation or discretion applied by supervisors. According to these criteria, an HFG is led by a FHC, which: i) controls at least 1 financial institution; ii) total assets are greater than or equal to 500 billion won; iii) the total amount of stock values of its subsidiaries exceed 50 percent of the total amount of its assets. This definition provides for a strong consistency of its application, providing high predictability of supervisory actions. However, there can be cases where supervision needs to employ additional quantitative or qualitative criteria to apply group level supervision to a holding company (and a group) which characteristics justify the exercise of financial conglomerate supervision, but it does not meet the strict quantitative limits. Such flexibility in qualifying criteria could support the enforcement of the conglomerate's transparency.

46. The financial authorities cannot require HFGs to take on a specific legal form or a group structure, however the FSC/FSS have some powerful tools to enforce transparency of these groups. Transparency of group structure is regulated through a set of rules, rather than principles that would allow for broader discretion on side of supervisors. Nonetheless, the FSC/FSS do have quite strong tools to enforce these rules. Specifically, the FSC/FSS can restrict a subsidiary of an FHC from owning stocks of another subsidiary or can require a subsidiary to only control financial institutions in related business as its second-tier subsidiary. In the case of NFGs, the supervisory tools are more indirect and include capital adequacy requirements for financial affiliates.

47. Additionally, any change to the group structure of the HFG is reported to the FSC/FSS, and is subject to regulatory approval.³⁶ For HFGs, FHCs are required to either report to, or acquire the approval of, the FSC/FSS when they plan on newly incorporating a subsidiary into the group. FHCs need to report to the authorities when they no longer control a certain subsidiary. (Article 16 – 18 and Article 61 of the FHCA) For NFGs, a 'representative company'³⁷ must report to the FSC on a quarterly basis on the current status of the group's ownership and governance structure, and any other changes. (Article 17 of the CPFC)

48. The information on a wider group of nonfinancial corporations, primarily relevant for NFGs, can be reached only through cooperation with the FTC, which can limit the FSC/FSS's authority towards groups. This is primarily relevant for supervision on the NFGs. In many cases this is sufficient, however the FTC has a specific mandate and information which it collects that may not always match the needs of supervision. Also, cooperation with the FTC is rather limited. Furthermore, there can be situations in which the FSC/FSS want to demonstrate their authority towards the

³⁵ The FHCA defines a financial holding company as a company which meets all the following requirements (the FHCA §2): i) It shall control at least 1 financial institution; ii) Its total assets shall be greater than or equal to 500 billion won; iii) The total amount of stock values of its subsidiaries shall exceed 50 percent of the total amount of its assets. For instance, the amount of assets can be a bit low than 500 billion won, but the activities of respective group may still require attention on a group wide level, as it is a systematically important group, where its members are strongly interconnected.

³⁶ An illustrative example of holding financial group (regulated by FHCA) is captured in Figure 4. It uses the same group of entities as the Figure 3 example. For a concrete group structure see Appendix VII.

³⁷ Defined as a financial institution within a NFG, that is a designated company, legally responsible for compliance with regulatory requirements on a group-wide basis towards the FSC/FSS.

conglomerates by directly requiring a specific piece of information, for the purpose of effective supervision. The proposal of the FSC/FSS to request such information through a 'representative company'³⁸ seems to be the most suitable, considering a possibility of potential enforcement.

49. The authorization of major shareholders provides a solid shield against a misuse of the financial system and safeguards soundness of the owners of financial institutions and groups.

The qualifications for major shareholders are one of the evaluation criteria for authorization to establish a financial company.³⁹ Compliance with the qualifications after the establishment of the financial company is subject to a regular review. The FSC/FSS check information about major shareholders against corporate and securities registries, and other publicly available information. The FSC/FSS verify the source of major shareholders funds and get assurance that there is a clear separation of industrial and financial activities. The information on qualifying holdings is part of reporting. The FSS cross-checks information from reporting with information available to the FTC.

50. Prompt corrective actions can be effectively adopted only for HFCs, as NFGs at the group level are not regulated by law, which is a significant gap in the current framework.

Considering that a wider range of supervisory judgement has to be applied on a broader variety of situations in the case of NFGs, the lack of this enforcement tool can hamper the effectiveness of supervision, as prompt corrective actions can often be used to mark the limits of prudent practice. Currently, the FSC/FSS can only recommend that NFGs take measures to improve the soundness of the group, for instance through a submission of a non-binding management improvement plan.

51. The recovery and resolution framework should be applied to domestic systematically important banking groups, to support group supervision with additional tools. The complexity of financial conglomerates should be reflected in the application of the recovery and resolution framework. Also, despite the increasing strategic importance of the overseas activity of Korean banks and the significant share of foreign banks in the Korean system, little thought has been given to managing a failure of cross-border firms. An approach needs to be developed, including a strategy for engaging relevant authorities overseas.

52. The legally binding prudential regulation for HFGs prevents multiple gearing and leveraging, limits contagion and concentration risk, and ensures sufficient levels of capital and liquidity, as well as adequate governance standards, in line with international standards.

The FHCA prohibits mutual stock ownership between the subsidiaries, places limits on the size of the credit exposures among the subsidiaries, etc., in an effort to prevent contagion risks that could be caused by intra-group transactions. Bank holding groups, in particular, are subject to additional regulations—in line with international standards, including Basel III. NFGs are expected to follow recommendations set in the CPFC, which proposes capital ratios calculated on an aggregate level for all financial institutions that are members of the same group.

³⁸ Defined as a financial institution within a NFG, that is a designated company, legally responsible for compliance with regulatory requirements on a group-wide basis towards the FSC/FSS.

³⁹ Includes financial holding company.

53. Specifically, for NFGs, the FSC developed the minimum capital ratio that is broadly inspired by the 1999 Principles,⁴⁰ and represents a reasonable step in creating a backbone of prudential requirements for NFGs. It compares aggregated capital of group financial institutions and sectoral capital requirements, taking into account double/multiple gearing among these institutions. Also, the NFG must calculate capital requirements for contagion and concentration risk. The FSC is currently working on the calibration of these capital requirements. It is recommended that they reflect the complexity and size of the group (including a wider group). The recommendations assign a ‘representative company’ of the NFG with a similar role as a holding company.⁴¹ A representative company is designated by the FSC/FSS. It is responsible for compliance with prudential standards on a group level and it is a primary contact point for supervision. For instance, NFGs are required to establish a risk-management consultative body, comprised of the representative company and other constituent financial affiliates, to manage group-wide risks and to coordinate and arbitrate various risk-related issues and interests. (Article 9 of the CPFC)

54. Although the capital ratio for NFGs has several conceptual limitations, it can be an efficient tool to increase transparency of NFGs. The ratio cannot fully capture the complexity of intragroup relations. Also, it cannot guarantee that capital would be available or could quickly be made available in the part of the group where losses and capital needs might occur. Additionally, it can be a challenge to assure the appropriate quality of capital. Nonetheless, the ratio is a good tool to address the general nature of group-level risks and to enforce prudent behavior of NFGs. Already, signaling to NFGs from the perspectives of supervisors that these NFGs are considered by the FSC/FSS as groups, with all related group-level risks, is an important step forward. Considering all limitations of this ratio, it should be used to promote an increase in the transparency of NFGs by providing strong incentives to streamline relations within a financial part of NFGs and to shield financial institutions from the risks of a wider (e.g., nonfinancial) part of the group. Ultimately, NFGs should benefit from transforming their structure to a transparent holding financial arm of the group.⁴²

55. HFGs are required and NFGs are recommended to disclose a detailed set of information about the group, to support their transparency. The current regime provides a solid basis that can be further enhanced through the framework currently considered by the FSC, which includes information about ownership structure, corporate governing bodies, financial conditions, and risk management strategies, but also specific data about intra-group transactions, capital ratios, etc. It is recommended the FSC expands the disclosure requirement in the direction already being considered. Specifically, the information about group structures would be an important element of this upgrade, motivating groups to strengthen their organization. A similar strategy is already used by the FTC. Disclosures are available in the “Data Analysis, Retrieval and Transfer System” (DART).

⁴⁰ Essentially, comparing the sum of sectoral risk charges and group level risks charges against the aggregate of financial institutions’ capital.

⁴¹ A financial institution within a NFG, that is a designated company, legally responsible for compliance with regulatory requirements on a group-wide basis towards the FSC/FSS.

⁴² Individual financial subsidiaries of NFGs are each subject to the requirements of the financial sector in which they are operating.

56. FSC/FSS established regulations covering corporate governance,⁴³ applicable to all financial institutions and financial holding companies, applying a consistent standard across the financial system. The Corporate Governance Act (CGA) governs the corporate governance of banks, securities firms, insurers, credit card companies, MSBs, and financial holding companies, and is backstopped by the Commercial Act (CA). Where there are not specific provisions in the CGA, an area may be covered by the CA. Specifically, the CGA includes requirements for the composition and operation of the board, requirements with respect to roles and responsibilities related to internal controls and risk management, and prudential requirements for large shareholders.

57. In line with international standards and good practices, boards are required to have adequate representation of independent directors. At least 3 members must be independent directors, and these must represent a majority of board members. Additionally, the board must have risk and audit committees. This applies at both the legal entity and the holding company level. The corporate governance rules also require the board's remuneration committee to deliberate and decide methods of determining and paying remunerations, ensure that no executive officer and employee take excessive risk when it creates a remuneration system, and defer the payment of remuneration payable to specific executive officers and employees. Each financial company is required to establish internal control standards by incorporating rules and integrity obligations with which the executive officers and employees should comply, for the soundness of business management and the protection of financial consumers. (Article 24 of the CGA).

58. The internal procedures of financial institutions (instead of supervisory reviews) on corporate governance are a basic instrument to ensure compliance with legal requirements, which represents a possible challenge for supervisory consistency and enforcement. The internal rules on corporate governance organize the corporate governance matters, including: the composition and management of the Board, establishment of a committee within the Board, the criteria for the expertise of executive officers, the evaluation of performance of executive officers, matters concerning succession to business control, such as the qualification for CEO. To ensure the sound management of financial conglomerates, the FSC/FSS require the board members (including persons who are not directors but who effectively conduct business affairs) to meet minimum qualifying prerequisites of integrity, while implementing various policy measures that secure the independence and expertise of the board members. Following the internal rules, financial companies are expected to submit to the financial authorities an annual report on the current status of the board management and operation, and to disclose it on relevant websites.⁴⁴ However, supervisors can be in a difficult position to achieve a uniform standard across the industry without their earlier involvement in the processes, benefiting from more intrusive approaches.

59. The FSC/FSS do not have the legal authority to evaluate board members and senior officers against specific qualification requirements and approve them for the positions, that substantially decreases accountability of boards with respect both to meeting expectations for responsibilities related to fit and proper assessments and running the firm in a safe and

⁴³ Regulations on Supervision of Corporate Governance of Financial Companies.

⁴⁴ Article 5 of the Regulation on Supervision of Corporate Governance of Financial Companies.

sound manner. Financial institutions, including FHCs, are required to develop their own internal fit and proper assessment processes. Financial institutions are responsible for reviews of the qualification requirements on on-going basis. The appointments do not require formal approvals by the FSC/FSS. Reviews in the context of regular supervisory assessments cannot fully replace these approvals as they miss the opportunity to formulate a concrete content of the accountability of board members and senior officers to supervisors at the beginning of their mandates. A similar logic applies to group level senior managers, where assessing their responsibility for an issue that occurred on the level of a subsidiary can pose a challenge, which is another critical weakness of the current framework.

60. The role of the FSC/FSS in assessments of major shareholders is complemented by the authority of the FTC, and these assessments would greatly benefit from enhanced cooperation between these agencies.

The authority of the FSC/FSS to assess the financial soundness and the integrity of major shareholders is defined by the CGA and is applied to all supervised financial institutions and financial holding companies. The regulation also defines detailed requirements for FHCs. For NFGs, a periodic group-wide risk management assessment of the group is recommended, evaluating the overall safety and transparency of the ownership and governance structure of the group. The role of the FSC/FSS is complemented by the broader mandate of the FTC. Currently, the FSC/FSS benefit from information collected by the FTC, however the cooperation of the FSC/FSS have a greater potential which should be explored.

61. The FSC/FSS established the regulatory framework for the overall corporate governance and sound organization of risk management, in line with international standards, specifically:

- **The board of the head of the group (an FHC or a ‘representative company’) is expected to be capable of understanding the group structure, management strategy and the material risks of the group.** The board of the FHC deliberates and makes decisions on matters concerning the group’s business management, such as the formulation of the group’s management strategies, the realignment of the group’s organizational structure, and the management of group-wide risks. In the case of NFG, the board of the representative company should have a grasp over the group-wide issues and risks of the group. (Article 9 of the CPFC)
- **The FSC/FSS require that the board of the FHC formulates capital management policies by identifying and assessing group-wide risks in a comprehensive manner.** It includes risks of unregulated entities. The board of the FHC is required to review and approve whether risk management strategies and capital management policies are consistent with its management strategies. (Article 12(2) of the Detailed Supervisory Regulations on Financial Holding Companies) Based on this, financial conglomerates should design its capital management policies that include crisis-situation analysis. The FSC/FSS require that the board of the FHC and recommends that the board (or the Risk Management Committee) of the NFG proactively

manages its capital.⁴⁵ The results of stress testing are expected to be reflected in capital planning and liquidity management processes, including as preparation for a crisis situation.

- **Similarly, the head of the group (FHC/representative company) is required/recommended to develop a group-wide liquidity management processes and funding programs.** These must be consistent with the group's scope of business, risk factors, and restrictions. (Article 29 of the Supervisory Regulations on Financial Holding Companies and Article 9 and Appendix 1 of the CPFC) The liquidity management process takes into account factors such as limits on the group's allowable risk size, managing an early warning system, conducting crisis-situation analyses, formulating contingency funding plans, diversifying funding channels and maturity periods, etc.
- **The regulations also require the boards of financial conglomerates to set and implement risk management and internal control standards; financial institutions are requested to establish an independent risk management unit.** The risk management and internal control standards delineate features such as the organization structure, the procedures and methods for group-wide risk management, including the administrative and accounting procedures of the group.⁴⁶ An internal control framework must be able to capture group-wide risks. Conglomerates are required to document the standards and processes, which broadly include matters such as the nature of business, issues related to various transactions, risks associated with the transactions and the interconnectedness of financial affiliates.⁴⁷
- **However, the FSC/FSS has only limited tools for requiring firms to address qualitative weaknesses that may impact a financial company's safety and soundness and should consider ways to strengthen incentives for banks to fix material risk management and control deficiencies.** As a starting point, addressing to boards and senior management the assessments and expectations for rapid remediation of weaknesses in areas the FSS views as of the most critical importance would be a welcome development. Such areas could include those related to supporting financial resiliency and compliance with conduct-related rules.

62. The FSC/FSS uses its broad authority to require comprehensive regulatory reporting from supervised firms and receives an extensive set of reports, but potentially not always matching the needs of cooperative efforts of the FSC, FSS, KDIC and BoK related to financial stability. The FSC, FSS, KDIC and BoK all have responsibilities for financial stability-related

⁴⁵ It includes a management system for internal capital adequacy while reflecting the assessment results of group-wide capital adequacy in their risk management and management decisions. (Article 12(2) of the Detailed Supervisory Regulations on Financial Holding Companies and Appendix 1 of the CPFC), as well as the determination of risk-taking limits, distribution of capital and the management of capital adequacy at the group-level. (Article 30 of the Supervisory Regulations on Financial Holding Companies and Article 9 of the CPFC) The integrity of the risk management system should be regularly reviewed (at least once a year).

⁴⁶ Article 24 and Article 27 of the Act on Corporate Governance, Article 29 – 30 of the Supervisory Regulations on Financial Holding Companies and Article 8 – 9 of the CPFC

⁴⁷ Article 11, Article 13 and Appendix 2 of the Regulations on Supervision of Corporate Governance of Financial Companies.

objectives. This review indicated, however, that the flow of information could be enhanced. Moreover, the information collected by/reported to the FSS may not include the full suite of useful information for these purposes. The agencies should convene a working group to discuss their potential data/information needs over the next 5-10 years and consider revising reporting requirements if needed.

Banks

63. Korea has implemented capital requirements in line with Basel 3. The 2016 Basel Committee on Banking Supervision (BCBS) RCAP found the capital regime to be “largely compliant”. Two elements were found to not be compliant: transitional arrangements and definition of capital. Both of these areas have been or were in the process of being addressed during the recent mission.

64. For banks, the minimum CET1 capital ratio is set at 4.5 percent, minimum Tier 1 capital ratio at 6.0 percent, and minimum total capital ratio at 8.0 percent. For Domestic Systemically Important Bank (D-SIBs) there is a capital surcharge of 1 percent, except for one D-SIB that is government owned, which is not subject to the surcharge due to the existence of a government guarantee agreement to ensure sufficient capital to maintain operations. The capital conservation buffer is 2.5 percent. The FSC may also turn on a countercyclical capital buffer ranging from 0 to 2.5 percent. Currently this is not mandated.

65. Recovery and resolution efforts are still being considered and assessments of recovery planning at D-SIBs should be given more attention. Recovery preparedness and planning is an important part of promoting resiliency at systemically important banks (SIB). Such banks should be held responsible for identifying a range of options they could take into account. Banks typically have their own “self-rescue plans”, which are less comprehensive than recovery plans and are not automatically activated by deterioration toward a possible crisis situation. However, these could represent a basis for development of the recovery preparedness procedures.

66. The lack of liquidity regulations at the consolidated holding company level constrains the ability of FSC/FSS to effectively evaluate group-wide liquidity risks and group-wide processes for managing liquidity risks across the entire firm. There is no Liquidity-Coverage Ratio (LCR) or Net Stable Funding Ratio (NSFR) requirement at the holding company level, which should be addressed as soon as is practicably possible. Discussions with FSS supervisors indicated they understand the importance of this gap and are working to implement requirements at the consolidated group level.

67. There are a variety of liquidity position requirements in bank-level regulations, including LCR and NSFR requirements that have been or are being implemented in line with Basel 3 standards. The 2016 BCBS RCAP review of the LCR found the Korean LCR regime compliant. In addition to the LCR and NSFR, Korean banks are subject to loan to deposit requirements of 100 percent, an FX LCR requirement of 80 percent and a variety of maturity mismatch restrictions.

68. The LCR for highly liquid assets and highly liquid foreign assets was introduced by revising the Regulation on Supervision of Banking Business (RSBB) (Article 26 and Article 63) and the revised Detailed Regulation on Supervision of Banking Business (DRSBB) (Appendix 3-6) in Dec. 2014. Except under stressed conditions, banks are required to continuously comply with the LCR for highly liquid assets and highly liquid foreign assets (on US dollar basis) and report an average outstanding balance on a monthly basis by calculating the LCR for each working day.

69. Basel III minimum LCR requirements (at 100 percent) apply to domestic banks on a consolidated bank-level basis. Banks are required to submit Business Reports on maturity mismatches of assets and liabilities each quarter and on monthly average LCR, daily LCR, and contractual maturity mismatches every month to the FSC/FSS for their LCR management - Appendix 3-6 of the DRSBB. The FSC/FSS enforces a separate FX LCR regulation for FX assets in recognition of Korea's unique characteristics as a small, open economy. There are also limits to FX maturity mismatches. For example, maturity mismatch requirements for mid-to long-term FX funding are as follows—all domestic banks (except those with less than US \$50 million in FX loans outstanding) must maintain the stable foreign exchange funding ratio⁴⁸ at 100 percent or above (90 percent or above for the Eximbank) (article 65 of the RSBB and article 39 and Appendix 14 of the DRSBB).

70. Domestic banks excluding Eximbank and small-scale banks⁴⁹ are subject to an FX LCR requirement,⁵⁰ which is set at a minimum of 80 percent (60 percent for Korean Development Bank (KDB)), article 63-2 of the RSBB, article 39 and Appendix 3-6 of the DRSBB. Maturity mismatch requirements imposed on the Eximbank and small-scale banks are as follows—the FX liquidity ratio⁵¹ must be at least 85 percent and the mismatch ratio⁵² must be above -10 percent (article 64 of the RSBB and article 39 and Appendix 14 of the DRSBB).

71. Policy banks face almost identical prudential regulations as commercial banks, but a weaker position of bank supervision can hamper the effectiveness of the overall framework. The FSC which plays a primary role in enforcement towards all other financial institution, takes in this case a role of a majority shareholder, leading discussions about their business plans, budgets, headcounts and KPIs. Although, the goals of a shareholder and a supervisor are not necessarily in all cases conflicting, this setup decreases the overall effectiveness of the framework and represents a constraint for the FSS to act independently towards these institutions. In addition, policy banks are supervised by other institutions, including the Ministry of Economy and Finance (MOEF), the

⁴⁸ The ratio of FX liabilities with a contractual maturity of more than a year relative to FX lending (including FX held-to-maturity securities) with a contractual maturity of a year or more;

⁴⁹ Banks whose FX liabilities are under USD500 million and less than five percent of the total liabilities.

⁵⁰ The percentage of high-quality liquid assets enough to fund cash outflows for 30 days.

⁵¹ The ratio of assets that will reach maturity in three months relative to liabilities with a maturity of three months or less.

⁵² The ratio of the difference between assets with a maturity of one month or less and liabilities with a maturity of one month or less relative to the total FX assets.

Presidential Board of Audit and Inspection, and the Parliament, which can undermine a leading role of the FSC/FSS in prudential supervision.

72. Banks are required to carry out regular stress testing of liquidity risk and FSC/FSS review the results and use check lists to ensure the stress test covers all areas that are expected. The results of the stress tests are expected to be used to guide liquidity risk management strategy, determine the liquidity risk appetite, adjust the holdings of high quality liquid assets, and design a contingency funding plan. The banks' stress scenarios are required to incorporate each bank's unique business characteristics and vulnerabilities so that the key liquidity risks can be adequately taken into account for each bank. The stress tests must use stress scenarios that incorporate both the bank's unique positions (and potential stress conditions) and market-wide stressed conditions.

73. Internet banks benefit from a less stringent framework, with the view of gradually aligning it with traditional banks' regulation in the majority of respects.⁵³ To support the development of this segment of banks, Korea decided to impose more favorable capital and liquidity requirements, following the Basel I framework. However, Basel III will be gradually implemented also for these banks, starting with 2020 (Appendix X). However, it is well understood that Korea wants to keep modernizing the banking system, the prudential framework should not be diluted and the level playing needs to be maintained. In this respect, the authorities are encouraged to proceed with the intended unification of prudential regulation for banks. Ultimately, the main difference in their prudential framework that remains is the requirements on the ownership structure, reflecting a specific business model that benefits from alliance with technological firms (that are permitted to hold more capital in internet banks than shareholders of traditional banks).⁵⁴

ODIs

74. The MSBs are required to hold a minimum 7 percent total risk-based capital (RBC) using a framework similar to Basel 1. For MSBs with KRW1 trillion or more in aggregate assets, the minimum capital adequacy requirement is 8 percent. It is recommended to impose the single limit of 8 percent and consider using the recent international capital standard as a basis for national legislation, implemented in a proportionate way. The rules can be simpler; however, the framework should not be less prudent in its result.

75. The MCCs calculate a net worth ratio relative to the aggregate assets, without applying risk weights. MCCs follow different limits of net worth ratio depending on the segment. Credit unions, fisheries cooperatives and forestry cooperatives must comply with 2.0 percent limit, while agricultural cooperatives are subjected to 5.0 percent limit, and community credit cooperates are required to stick to 4.0 percent limit. The underlying logic of different limits is not obvious.

⁵³ See Appendix X. – Prudential Framework for Internet Banks.

⁵⁴ For Internet banks, non-financial entities may hold up to 34 percent of the shares of the bank with voting rights. The limit on share ownership takes into account shares held by the same person (including specially related persons). While for traditional banks, non-financial entities' stake is capped at 10 percent (no voting rights granted for shares in excess of 4 percent) of the shares of a bank.

However, none of them reaches levels recommended as good practice by international organizations of cooperatives and their regulators.⁵⁵

76. Additional ratios are in place to steer prudential requirements, including liquidity ratio and loan-to-deposit ration.⁵⁶ Simple liquidity ratio is applied to MSBs and MCCs, focusing on short term liquidity. MSBs shall maintain their liquidity ratio (liquid assets and liquid liabilities that mature within three months) above 100 percent pursuant to Article 40-4(3) of the Regulation on Mutual Savings Bank Business. The ratio for MCCs is identical, but no limit exists for them. This basic liquidity ratio requirement does not accurately reflect the extent to which an institution engages in asset-liability mismatch and liquidity/maturity transformation. It is recommended to develop more accurate measure taking into account a specific structure of MSBs/MCCs' balance sheets. For MCCs, the limit should be applied, although national federations of MCCs follow their own frameworks supporting liquidity risks management considering liquidity status of individual cooperatives. While for MCCs, the loan-to-deposit ratio is in place, MSBs should comply with a similar set of rules from 2020, with a phase-in-period. The efficiency of the loan-to-deposit ratio is decreased by the fact that it combines a prudential perspective with government's social policy goals (certain loans are exempted from calculation). Asset classification and minimum reserve requirements are harmonized from 2020 on, as well.

77. However, the upgrades of regulation resulting in a more prudent and consistent framework should continue beyond 2020. The authorities have been gradually converting the framework for MCCs and MSBs to achieve more convergence in regulations for individual segments of ODIs. The current program of regulatory reforms contains initiatives that go until 2020. The authorities are encouraged to continue this program and to adopt a new medium term strategy of reforms, to enhance level playing field across deposit taking institutions and to increase prudence of regulatory requirements, including their alignment with international good practice.

Insurance

78. The objectives of insurance supervision are defined in the IBA. According to article 1 IBA, the objectives are: (i) ensuring the sound management of insurance companies; (ii) protecting the rights and interests of policyholders and other interested parties; (iii) promoting the insurance industry; and (iv) contributing to the balanced development of the national economy. Details on the FSC's and FSS' responsibilities and powers are further laid out in the Enforcement Decree of the Insurance Business Act (EDIBA), the Enforcement Rules of the Insurance Business Act (ERIBA), the Regulation on Supervision of the Insurance Business (RSIB), and the Detailed Regulation on Supervision of the Insurance Business (DRSIB).

⁵⁵ For instance, the World Council of Credit Unions (WOCCU), where the National Credit Union Federation of Korea is a member, recommends, that "the minimum capital-to-asset ratio for credit unions should be 10 percent of total assets. Components of capital include retained earnings, donations and statutory reserves. Member shares are not considered capital."

⁵⁶ See Appendix IX. - Selected Prudential Limits for Deposit Taking Institutions.

79. The valuation of liabilities under the RSIB is based on current international accounting standards, meaning that liabilities are measured at cost in accordance with International Organization of Securities Commissions (IFRS) 4.

A fair value measurement of liabilities will be introduced when IFRS 17 replaces IFRS 4, currently scheduled for 2022. As Korea is committed to the full adoption of IFRS, FSC/FSS are expected to fully implement IFRS 17 and revise the RISB accordingly once the International Accounting Standards Board (IASB) decides on the implementation details. In order to complement the cost accounting method under the existing standards, insurance companies are required to assess the adequacy of liability reserves. Insurance companies should calculate the current estimates of future cash flows from insurance contracts (similar to fair value) and additionally set aside any difference with the liability reserves calculated at cost in order to better reflect the impact of changing economic conditions on the value of liabilities.

80. Asset values are determined based on IAS 39 and therefore broadly incorporating an economic valuation.

However, after the implementation of IFRS 17, the measurement will be based on IFRS 9. As assets are measured in accordance with international accounting standards that adopt the fair value approach, economic conditions are reflected in the measurement of assets.

81. The FSC/FSS has introduced and subsequently strengthened an RBC regime for solvency purposes.

Pursuant to Appendix 22 of the DRSIB, insurance companies are required to calculate their available capital and required capital based on consolidated financial statements in accordance with K-IFRS. RSIB requires insurers to compute available capital by considering the quality and permanent nature of capital resources and accordingly measure tier 1 capital, tier 2 capital, deduction items, and others. Several reforms of the RBC were introduced since the last FSAP, amongst others, the charges for interest rate risk and credit risk were raised in July 2015, and a group capital regime, were introduced in 2016.

82. The RBC level determines the need for corrective actions.

In case the RBC ratio falls under 100 percent, prompt corrective action is triggered in order to help insurance companies improve their financial soundness through a set of means such as capital increase. The FSC imposes a management improvement recommendation (MIR) to insurance companies with the RBC ratio ranging between 50 percent and 100 percent. A management improvement demand (MID) is imposed to insurers with the RBC ratio ranging between 0 percent and 50 percent. Finally, a management improvement order (MIO) is imposed by the FSC to companies with the RBC ratio below 0 percent.

83. When calculating the required capital, a standardized approach is in place which covers insurance risk, interest rate risk, credit risk, market risk, and operational risk.

Internal model approaches using insurers' own statistical data are currently not allowed, but from 2020 onwards, insurers can apply for the use of such models.

84. The solvency regime is currently being updated with an implementation date scheduled for 2022, together with IFRS 17, which will determine the valuation of insurance liabilities.

The FSS has run two quantitative impact studies on the new fully risk-based solvency regime, the K-ICS. Results of these field tests are not publicly available but will determine the calibration of the RBC and the need for a phase-in approach.

85. The Governance Act and the IBA require insurance companies to have effective systems of risk management and internal controls, including on a group level. Key control functions are prescribed for risk management, compliance, actuarial matters, and internal audit. Internal control standards include: (i) segregation of duties; (ii) establishment of an organizational structure; (iii) clarification of the roles of the BoD, executives, and compliance officers in relation to internal control; (iv) establishment of an effective reporting system for managerial decision making; (v) enforcement against employees who violate internal control standards; (vi) processes or standards for prevention of violation of finance-related laws and regulations; and (vii) methods and procedures to manage conflicts of interests.

86. Insurance companies are required to establish an ORSA. It aims at identifying, assessing, monitoring, and controlling risks arising in the course of insurance business operations, asset management, and any other business activities, in order to adequately manage risks and assess internal capital. The ORSA—implemented in 2016, but not applied yet by all companies as the FSC/FSS has granted a phase-in—requires insurers to measure and manage major risks that arise from their transactions such as insurance risk, interest rate risk, market risk, credit risk and operational risk. Insurers should set and comply with risk tolerance limits and transaction limits by risk covered, transaction, division (trading unit), and employee.

87. In order to ensure prudential asset management, FSC/FSS regulates investment activities of insurance corporations with a set of limits and restrictions. Article 104 of the IBA requires insurance companies to ensure stability, liquidity, profitability, and public interests when they manage assets. Limits are in place with regard to certain asset classes, credit extensions and trading with large shareholders. Insurers should also keep liquidity ratios above certain levels. Under Risk Assessment and Application System (RAAS), investment risk is managed and supervised by evaluating quantitative indicators such as investment risk ratio, non-performing asset ratio, and coverage ratio.

88. The Korean effort to implement the long overdue fully risk-based solvency regime in line with international best practices is a welcome prudential enhancement. While much of the public discussion on the K-ICS focuses on the perceived capital shortfall and the necessity of transitional measures to phase in the new regime, this discussion should not overshadow the need for structural adjustments in the life insurance sector. The FSC/FSS should assess the long-term viability of business models and, for companies with a weak solvency position and low or negative profitability, also evaluate the financial strength of shareholders as well as the possibility of capital injections. Consideration should also be given to deal with high-guarantee legacy business, e.g. by evaluating the legal basis for portfolio transfers, run-offs and conversion offers. For companies with a very distinct risk profile and weaknesses in governance structure or internal control functions, the possibility of explicit Pillar 2 capital add-ons should be considered. Longevity risks, which are expected to rise in the future, should be addressed with a prudent calibration of the respective capital charge which should not only build on historic experience but also incorporate expected changes in policyholder behavior.

Asset Management and Collective Investment Schemes (CIS)

89. The overall regulatory structure governing CIS is robust and based on international standards. It is broadly compliant with the IOSCO principles and standards although there are still some areas that are presently in the pipeline for introduction. There are relevant standards in place for the eligibility, governance, organization and operational conduct of those who wish to market or operate a CIS.

90. The main legal framework for CIS is the Financial Investment Services and Capital Markets Act (FSCMA), which consolidated the Securities and Exchange Act, the Trust Business Act, and the Indirect Investment Asset Management Business Act, and took effect in February 2009. Among others, the FSCMA provides for a “negative list” system, introduces function-based regulation, and strengthens investor protection. In addition, the CGA that integrated corporate governance laws in different financial sectors was introduced in 2016 in response to calls for enhanced role of the board and the audit committee in improving corporate governance and stricter rules for corporate governance.

91. In Korea, funds are classified according to the number of investors who receive investment solicitations and the number of investors who participate in the investment. If the number of solicited retail investors and the number of participating retail and professional investors (excluding institutional investors) are each 49 or fewer, the fund is classified as a privately offered fund. If both numbers are 50 or more, the fund is classified as a publicly offered fund. Publicly offered funds are regulated under the FSCMA, and privately offered funds are subject to special provisions and regulated by way of exempting certain regulatory provisions that are applicable to publicly offered funds.

92. There are specific requirements on governance and ownership structure of the asset management companies including for those that are part of conglomerate groups. There are currently five asset management companies that are part of conglomerate groups in Korea. One of the regulatory concerns is preventing any person not meeting the requirements for a large shareholder from operating a financial investment service business by acquiring shares. In this regard, the CGA provides that a person who seeks to become a large shareholder of a financial investment service provider by acquiring or obtaining shares issued by the provider must satisfy conditions for a change in large shareholder and apply for pre-approval from the FSC. The FSC has the authority to order a large shareholder to dispose of shares acquired without FSC approval within a six-month period. A large shareholder who has acquired shares without FSC approval may not exercise voting rights attached to the unapproved shares. All asset managers including hedge fund managers are prohibited from trading with their large shareholders such as acquiring securities issued by them and extending credit to them. The eligibility assessment of large shareholders is conducted every two years

93. Asset managers managing publicly offered funds are required to keep their capital above the minimum operating capital as a prudential measure. Minimum operating capital for each licensed business is the sum of capital required to be maintained, capital required for

managing investor assets, and capital required for managing proprietary assets. The specific calculation methods for each class of the capital are set forth in the Regulation on Financial Investment Business and the Detailed Regulation on Financial Investment Business. Asset managers are required to set up a risk management system including a risk management team (or group) and risk management guidelines designed to identify, assess, monitor and control all risks arising from trading. The FSCMA does not impose restrictions on investment in foreign assets by asset managers, and according to the FSS, there are no segments within the overall financial system which manages pools of money but are not subject to direct oversight by the FSC/FSS.

94. A trust business entity of a CIS manager checks whether the CIS manager complies with regulations such as leverage limits, limits on the risk amount from derivatives trading, and the use of securities financing. If the trust business entity finds a violation, it should demand corrective measures from the CIS manager. If the manager does not carry out the corrective measures within three business days, the trust business entity should report it to the FSC.

95. There are relevant requirements in place for the custody and management of CIS assets. The custody and management of the CIS assets should be entrusted by the CIS manager to a trust business entity. A trust business entity owes investors the fiduciary duty of due care in managing CIS assets. Accordingly, it must carry out the business in good faith for the purpose of protecting investor interests and segregate its proprietary assets and CIS asset. The affiliates of a CIS manager are not allowed to be the trust business entity that manages and holds the custody of CIS manager's CIS assets.

96. The general basis of valuation of CIS assets in Korea is in compliance with the IOSCO principles but there is a need to accelerate the implementation of the IOSCO MMF Recommendations. This is an important area that requires a proper and disclosed basis for asset valuation, pricing and redemption of units in CIS. The Korean regulators have generally ensured that the key aspects are in place. However, the valuation of MMF should use market value or fair value as required by the IOSCO Policy Recommendations on MMF.⁵⁷ The authorities have informed the mission that this is in the process of being implemented. Korea also has been rather slow in introducing the reforms which was a point that was also previously highlighted in the last FSAP.

97. The CIS framework in Korea includes a range of safeguards to promote liquidity management. There are investment limits imposed at the portfolio levels (such as diversification limits both by asset type and issuer); relevant policies and procedures for liquidity risk management and stress testing; and specific disclosure and regulatory reporting on liquidity.

98. The FSCMA has requirements for each fund category, that specifies the types of assets that can be invested, investment limits on similar asset class, and restrictions on the level of derivatives trading. It should be noted that the FSCMA imposes investment limits by asset class, not by type of CIS. In addition, there are separate regulations for MMFs. The regulations applied for

⁵⁷ The assessment is based on the regulation effective by June 30, 2019. Shortly before the publication of this Note, legal changes requiring the market-value assessment and stress testing of institutional MMFs were adopted.

privately offered funds are much less onerous than those applied on publicly offered funds. Given the importance of liquidity management for MMFs, the level of restrictions is even stricter for MMFs. Asset managers are also required to divide MMFs into MMFs for retail investors (“retail MMFs”) and MMFs for legal entities (“institutional MMFs”) and have them managed accordingly.

99. There is clear recognition of potential risks to financial stability from a liquidity crisis emanating from large sell-off orders by MMFs. Given the sensitivity of institutional MMFs to situations of severe market stress, selling by institutional MMF investors may trigger a major run further precipitating a decline in asset prices. In order to prevent a potential spread of systemic risk from such a run on the funds, the FSC/FSS has proposed⁵⁸ rule changes requiring asset managers to periodically conduct stress testing on MMFs and require marked to market valuations for institutional MMFs.

100. There are relevant regulatory requirements and limits on the use of leverage with reporting requirements to the regulators. Borrowing is allowed only for hedge funds; it is not allowed for publicly offered funds (excluding real estate funds). Borrowing limits are determined by the leverage ratio with leverage determined as the sum of the amounts borrowed, risk amount from derivatives trades, and debt guarantee or the amount of collateral provided. Derivatives-based leverage is primarily used for FX hedging and other hedging purposes.

Audit Framework

101. The audit framework is a very relevant component of conglomerates supervision, with the focus on assurances on the group level.⁵⁹ In this sense, FSAP identified a gap in the current regulatory framework, as group auditors are not required. Also, the regulation does not require a cooperation and information exchange among auditors of the financial conglomerate’s companies that could supplement the group auditor requirement. Such requirements are important for efficient conglomerates supervision, as they can provide additional checks on relations across groups, and above all on the quality of capital in financial institutions. The authorities are recommended to consider a group level audit framework, compliant with the overall legislative framework.

102. The 2013 FSAP identified some gaps in the overall oversight of the auditors. The current FSAP did not conduct a full scope review of the audit and auditor oversight regime, but as there were some gaps identified in the previous FSAP, a questionnaire was sent to the authorities and based on the responses and a discussion with the authorities mainly FSC and FSS, the review

⁵⁸ The assessment refers to the situation by June 30, 2019.

⁵⁹ A particular attention to the audit framework is paid also by securities regulators. The proper operation of the capital markets depends on accurate and complete financial reporting by public issuers and financial firms, backed up by diligent audits by independent auditors. The IOSCO principles recognize this key role for audit and expect that there be a complete and effective framework for audits and auditors as part of the overall regulatory regime for capital markets. The IOSCO standards expect three aspects to be fulfilled by the audit framework: (a) independent, qualified auditors operate, and are seen to operate, in an environment that supports objective decision-making on key issues having a material effect on financial statements; (b) audits are performed using high-quality auditing standards; and (c) the reliability and integrity of the financial reporting process is supported by effective oversight of those performing audit services by a body independent of the auditing profession and acting in the public interest.

below is presented. Among the areas identified by the 2013 FSAP was the need to strengthen the quality control requirements for audit firms that audit listed companies and financial institutions; the requirement that audit oversight programs should be sufficiently comprehensive and address the risks of non-compliance with the market rules; and that there is enforcement of any violations of the independence and quality control requirements.

103. An overall review of the structure in Korea shows that Korea has the requisite requirements for independence of auditors and accounting and auditing standards that are aligned to international standards. Accounting standards used by issuers to prepare financial statements since 2011 have been based on international standards with the adoption of IFRS. This is reflected in the relevant provisions in the Enforcement Decree of the FSCMA and the Enforcement Decree of the Act on External Audit of Stock Companies. The Act on External Audit of Stock Companies stipulates the scope of companies, which are subject to external audits and the threshold criteria for small sized companies that are not required to have external audits.

104. Auditors are subject to adequate levels of oversight but there is a need to continue strengthen the oversight regime and accountability of auditors as well as the enforcement and sanctions regime to address the risks of accounting and audit fraud. Several reforms have been introduced at the end of 2018 to the Act on the External Audit of Stock Companies and are in the pipeline for implementation. It remains to be seen how effective the actual implementation efforts will be to enhance the quality of audits for listed firms as well as regulated entities and provide a credible deterrence against accounting fraud and poor audit quality. While the authorities are to be commended for introducing the various reforms in the area, it is recommended that the authorities intensify efforts to implement these provisions and address the issues of accounting fraud and audit quality that continues to exist in Korea.

105. The authorities have worked towards strengthening the enforcement of violations on independence and quality control requirements. The amendments to the Act on External Audit in November 2018 was also done to further raise auditors' quality control standards and practices. Specific provisions on enforcement have been provided for the CEO and the audit quality control officer of an audit firm for negligent audits when a serious audit flaw is uncovered in a publicly traded company. In addition, as mentioned above a new registration regime has been introduced for audit firms performing audit of publicly traded companies so that only accounting firms satisfying certain levels of physical facilities and quality control standards can be permitted to perform audit of publicly traded companies. There are also plans under consideration to publicly disclose quality control recommendations by supervisors following audit reviews and the names of auditing firms that fail to comply with supervisor-issued recommendations.

106. The authorities should accelerate the implementation of the reforms to address risks of accounting and audit fraud. The initiatives to strengthen the audit and accounting oversight should continue to achieve a comprehensive quality assessment of audits.

107. The authorities are also encouraged to expand auditors' obligations beyond the audits of financial statements. This is particularly important for supervision of financial institutions. It is good practice to assign auditors with additional tasks related to their annual audits. These assignments can contain the accuracy of regulatory reporting, or the effectiveness of internal control processes, including risk management, and systems. The auditors should be required to report major flaws and failures to the FSC/FSS. These obligations should be also established on a group level.

C. Supervision and Supervisory Cooperation

Summary

108. As an integrated supervisor, the FSC/FSS is well positioned to carry out strong, group-wide supervision. The current supervisory approach for financial groups is organized around legal entities, with a relatively small team of "group-level" supervisors. Given the systemic importance of these groups and that growth is being driven largely by non-bank activities, the authorities will need to continue to develop and implement more group-wide supervision practices. The authorities should further elaborate their supervisory approaches to capture additional dimensions of group organizations' risks. Multilayer analyses of conglomerate maps, which captures the relationships between the group structure, the quality of capital and risks' dynamics within the groups, including for the cases of crisis situations, would significantly elevate supervisory outcomes.

109. The reliance on a rules-based approach may hamper the FSS' supervisory ability to proactively address new and emerging risks in the financial sector. When rules restrict financial institutions from certain activities and risks, they may find ways that are not directly constrained by regulation. Supervisors play a key role by identifying such behaviors and requiring effective internal practices at financial institutions to identify and incorporate them into their assessments of capital and liquidity needs.⁶⁰ The FSC/FSS should consider greater use of forward-looking approaches and measures which requires significant changes to laws and regulations that currently are not particularly supportive of *ex ante* actions when institutions' risk management practices are deemed to be less than adequate, but no violation of rules and regulations has occurred.⁶¹

110. There should be greater emphasis on in-depth qualitative assessments of critical group-wide practices. These include Credit Risk Management, Internal Capital Adequacy Assessment Process (ICAAP), Internal Liquidity Adequacy Assessment Process (ILAAP) and recovery planning. To support this, the Korean supervisors need the authority to put in place meaningful requirements and expectations/guidelines in these areas on a group-wide basis. While the FSS has implemented ICAAP requirements for capital planning and stress testing requirements for liquidity risk management, reviews of these practices could be strengthened and forward-looking measures

⁶⁰ For instance in insurance, the FSS should consider more forward-looking and qualitative components in the RAAS process.

⁶¹ Overall, the interaction of supervisors with the boards of directors could be more intrusive. It should include the assessment of their effectiveness, including at holding companies. Also, boards and managements need to be held directly accountable for weak practices, either enterprise-wide or for important subsidiaries.

of financial condition could be better integrated into the rating framework and supervisory outcomes interactively communicated with banks, and most importantly for DSIBs at the consolidated group level. Evaluations of banks' internal capital assessments can play an important role in promoting bank resilience and feed into Pillar 2 assessments framed by a formal annual supervisory review process, at least for large banks, as done in other jurisdictions. Similarly, in insurance, annual ORSA reports should be used to provide systemic feedback in the form of a risk dialogue to individual insurance corporations.

111. Supervision of corporate governance requires further enhancements, particularly at the holding company level. As discussed in the previous sections, a lack of direct assessments of the effectiveness of holding company and bank level boards and senior management in the current framework is a significant gap of the current framework.

112. Supervisors need to strengthen their supervisory approaches towards external auditors across groups. A qualitatively rich exchange of views with external auditors, corresponding with crucial phases of audits of systematically important financial institutions and groups, should be further developed. It is important to give auditors regular feedbacks and discuss cross cutting issues relevant for multiple types of financial institutions, to promote consistency of external auditors' approaches and to get additional assurance of the financial system's soundness. A group level perspective should be included in dialogues with relevant external auditors.

113. The prudential supervisory approach for state-owned banks, mutual savings banks and ODIs is a concern, with potential consequences for financial conglomerates. The FSS's ability to promptly act in an even handed and prudential way is limited by a lack of competent jurisdiction and/or delegation and freedom to take prompt supervisory action towards these institutions, which in a number of cases operate within groups. Furthermore, pursuing economic and social goals via commercially oriented financial institutions erodes the soundness of the system and hampers the level playing field across the financial sector.

114. Although Korea has established an overall well-functioning securities markets supervisory structure, instances of mis-selling and misconduct have begun to rise, negatively influencing the reputation of some groups. The underdeveloped consumer and investor protection framework in Korea could impact market confidence, if risks related to severe redemption and liquidity pressures in the funds and asset management industry are not recognized and addressed. The authorities should: (i) fully implement the key IOSCO Money Market Funds (MMF) recommendations; (ii) conduct stronger surveillance of capital market and nonbank risks accompanied by a more regular inspection program; (iii) develop a systemic risk framework that incorporates the securities sector and features stress tests on the asset management industry particularly for MMF funds; and (iv) accelerate the implementation of the reforms to address risks of accounting and audit fraud.

Financial Conglomerates

115. The FSAP focused on supervisory practices towards holding financial groups (HFGs), as supervision of nonholding financial groups (NFGs) is only just now being launched. The FSAP identified a solid standard of the supervisory framework for HFGs and the commitment of supervisors to implement the framework for NFGs.

116. The supervisory practices for financial conglomerates need to be enhanced to be able to capture and address potential systemic risks for the financial system, and to increase compliance with international standards. Recovery and resolution efforts are still a work in progress and assessments of recovery planning at large groups has not been introduced. An emphasis on evaluations of key forward-looking practices at the group-wide level could enhance the supervision process, as well as greater focus on group-wide risks and group-wide practices for controlling and managing them. Supervisory activities for assessing the effectiveness of the group level governance—including boards of directors and senior managements—remain underdeveloped, a greater emphasis on in-depth qualitative assessments of critical group-wide practices such as Credit Risk Management, ICAAP, ILAAP needs to be established. The overall group supervision framework shall be developed to cover all financial conglomerates, including non-holding financial groups. It should incentivize groups in maintaining transparent and robust group structures and empower supervisors through legally binding prudential requirements applicable to all financial conglomerates.

117. Enhanced cooperation of the FSC/FSS with the FTC, which is assigned with a specific role in conglomerates supervision, could expand the FSC/FSS's perspective. The FTC regulates a wider range of significant conglomerates, beyond financial groups. Although it is primarily mandated to supervise antitrust rules, its focus is broader and includes transparency of groups or consumer protection. The FTC has a complete picture of conglomerates structures. These structures are published annually, to encourage their transparency.⁶² The FTC monitors intragroup large transaction,⁶³ including guarantees, to prevent multiple gearing and hidden leverage. The FTC has power to file criminal charges against the members of BoDs, in the case of inaccurate information reported to the FTC (qualified as a criminal act). The FTC regularly meets BoDs of conglomerates to discuss its views. The cooperation with the FSC/FSS is rather limited although all authorities could significantly benefit from such cooperation and leverage their positions towards conglomerates.

118. The state policy functions which are entrusted to many financial institutions and groups can pose some additional challenges for supervision. These policy mandates of financial institutions extend their roles in financial intermediation and bring another layer of complexity to the organization of their activities and processes, including risk management. In some cases, these additional complexities apply to a group level. Policy institutions are typically related to the underlying activities, which are supported by a respective policy function, not only through their

⁶² www.egroup.go.kr

⁶³ Ammounting at least 5 bn KRW or 5 percent of the group's overall assets.

mandates, but also through relations to their groups and/or beneficial owners.⁶⁴ Although, the FSC/FSS adopted a set of measures to ringfence FHGs from the most prominent risks, some structural weaknesses prevail. All these circumstances put supervision in a very delicate position. It is important for supervisors to stick to their traditional roles, apply conventional tools and approaches, and safeguard a level playing field. This applies to both enterprise- and group-level supervision.

119. An emphasis on evaluations of key forward-looking practices at the group-wide level (for bank-led FHCs) could strengthen the supervision process for FHCs through periodic in-depth examinations of these practices. Specific practices warranting such reviews could include credit risk management, ICAAP and capital planning, ILAAP and liquidity planning and recovery planning. Supervisory emphasis on forward-looking practices and techniques can play an important role in promoting financial resiliency by making clear to boards and senior managers of FHCs that ensuring effective group-wide practices in these areas are important elements of their roles and responsibilities and that they will be assessed against these responsibilities. These periodic assessments should factor into evaluations of board and senior management effectiveness.

120. As an integrated supervisor, the FSC/FSS is well positioned to carry out strong, group-wide supervision of HFGs, and should take full advantage of this by further enhancing its focus on group-wide risks and group-wide practices for controlling and managing them. The current approach to supervision of banking and insurance groups is primarily organized around supervision of legal entities, with a relatively small team of “group-level” supervisors.⁶⁵ Given the systemic importance of these groups and that growth is being driven largely by non-bank activities, the FSS will need to continue to develop and implement more group-wide supervision practices. As with all financial conglomerates, understanding group-wide risks and vulnerabilities—including those stemming from intercompany transactions—is critical for effective supervision.

121. The FSS collects conglomerate maps and other data and information on financial conglomerates providing some crucial insights, if connected to a holistic picture of the group level risks. A comprehensive approach that could enhance the existing analyses should encompass these areas: ownership structure, control established by contractual arrangements, profit/loss sharing arrangements within the group, guarantees and other instruments transferring risks between entities of the group important capital and liquidity flows (including smaller but frequent amounts), other arrangements potentially establishing major dependencies among members of the group, potential recovery and resolution arrangements. These pieces of information analyzed and assessed altogether—as dimensions of conglomerate maps—can improve the understanding of relations within the group, and the identification of additional weaknesses and hot spots.

⁶⁴ See the example in Appendix XI. – Organization of National Agricultural Cooperatives Federation.

⁶⁵ See Appendix V. – Organization Chart of FSS with Focus on Group/Cross-Sectoral Supervision, reflecting the FSS’s growing emphasis on the coordination of group supervision activities. A similar approach to internal organization has been adopted by the FSC to correspond with the FSS’s approach (see Appendix IV. – Organization Chart of FSC).

122. The currently underdeveloped approach to consolidated supervision represents a lost opportunity given the FSC/FSS' role as an integrated supervisor covering all financial sectors.

With supervisory responsibility for all major financial system sectors, the FSS is well positioned to implement a comprehensive and effective consolidated supervision program with heightened emphasis on recently designated D-SIBs at the group level. Efforts to enhance its group-wide approach should be continued and strengthened, including putting in place more resources specifically focused on group-level risks and practices. Current approaches involve input and collaboration from a number of different stakeholders within the FSS. These include teams from the Bank Supervision Department, the Bank Examination Departments, the Bank Risk Office and the Financial Group Office. However, the collaborative efforts, in the absence of a stronger focus on the group level, may also create unnecessary complexity and heighten the risk that important issues arising at subsidiaries could be lost in the communication.

123. For oversight at the holding company level, participants from the different supervision sectors – e.g., banks, insurance and securities firms – have a variety of systems for sharing information and come together as a group when planning comprehensive examinations.

However, examinations are typically carried out within the subsidiaries by supervisors from the sectoral departments of each subsidiary. Greater cross-sector focus of key risks and risk management and control tools would enhance FSS supervision of groups.

124. For bank led HFGs the FSS uses the RFI assessment framework, which guides reviews organized in 2-3 years cycles depending on the size of the group. FSS assesses FHC's using RFI assessment framework, which reviews three elements – i.e., Risk Management (R), Financial Condition (F), and Potential Impact (I). Considering the assessment results of the three elements and overall management condition, a composite rating is calculated based on specific weightings for each category. The RFI is built largely on inputs from sectoral supervisors, who participate in preparatory work for RFI examinations. The FSS directly requests and meets with the FHC's representatives, for instance group-level audit committee. Outside of the 2-3-year cycle, the rating is generally not up-dated. The cycle is not synchronized across institutions. The communication of results to the institutions is not formalized.

125. Over recent years the FSS has increased the use of thematic cross-sectoral reviews to focus in on key risks and risk management practices. A recent review—the first of its kind—applied this cross-sectoral approach, looking at a specific activity across HFG's subsidiaries in different sectors that were identified as posing the greatest risk. This activity-based approach is good practice and the reviewers encourage greater use of it. We would recommend that firm-specific examinations also take a cross-sectoral perspective to enhance the overall understanding of the vulnerabilities across entities within HFG. In addition to offsite monitoring and analysis efforts, FSS supervision emphasizes periodic onsite “comprehensive examinations” and targeted/thematic reviews. The FSS has significantly increased the use of risk—or activities—focused thematic and/or targeted reviews since the prior FSAP and the reviewers encourage them to continue to build on this progress.

126. There may be opportunities to enhance overall effectiveness of FSS' supervision by either increasing total staffing levels for large financial conglomerates directly or rebalancing resource allocation across different parts of the framework. In particular, for large institutions, including DSIBs, supervisory intensity should be increased, and more focus could be given to top-to-bottom reviews of critical practices for promoting financial resiliency. These should include reviews of group wide ICAAP/ORSA and capital planning to provide for concrete assessments of important supporting practices such as risk identification, management and controls. This would allow the FSS to assess all aspects of that groups' practices from identifying and measuring risks, to ensuring full and timely capture of all positions, internal controls around key risk data and information, reporting to management and the board and the role of internal audit in providing boards with a solid understanding of the strengths and weaknesses of the critical processes supporting their decision-making about capital needs.

127. The group-wide internal capital processes (ICAAP/ORSA) should be fully integrated across groups and weaknesses at any subsidiaries should be required to be addressed by group-level boards and management. As recommended by the 2013 FSAP, the FSC/FSS introduced a rule to require ICAAP at the subsidiary and group level in 2016 and should ensure effective comprehensive and integrated group-wide ICAAPs at D-SIBs are being carried out and assessed by supervisors. ICAAP 'reviews' are a key part of the annual Risk Assessment process done by the FSS. These reviews consist largely of reading and analyzing the required annual ICAAP report required of banks and the holding companies. The process to date is still under development at the group level. Banking groups' legal entities carry out some entity-level analysis and the holding companies consolidate those. Similarly, in insurance, the ORSA was introduced in 2016, and while all companies have developed implementation plans, the FSC/FSS has granted a phase-in for many companies. For those companies that already submit an annual ORSA report, findings from the review of these are incorporated into the risk assessment, but no systematic feedback in the form of a risk dialogue is provided to the companies.

128. Supervisory efforts for the assessment of banks' internal capital assessments and capital planning should be enhanced by conducting periodic in-depth supervisory reviews of these processes. Currently, in depth oversight of ICAAP at banks is largely carried out by internal audit departments at the subsidiary level, with reporting on their assessments going to the FSS annually. Group-wide ICAAP should be an integrated process and the FSS should evaluate that firms capture all material risks across the group and incorporate them into considerations of capital needs. This should include an assessment of whether the BoD is getting the information it needs to make informed decisions about capital needs at each subsidiary and on a consolidated group level.

129. FSS supervisors does not directly assess group-level liquidity risk management for HFGs. Group level liquidity risk management is critical for large banking organizations that may be active in a variety of businesses through different legal entities and in different jurisdictions. Given large Korean banks' and insurance corporations' plans to continue expanding overseas operations and expand other financial intermediation activities, lack of group level liquidity risk requirements

and supervision is a significant shortcoming in the oversight of the financial system, even if sector-level requirements may appear to be effective for each subsidiary.

130. Supervision of corporate governance remains a work in progress, particularly at the holding company level. It may be hampered by a lack of direct assessments of the effectiveness of holding company and bank level boards and senior management in the current rating framework. Currently, for bank-led holding companies the supervisory focus continues to be on the primary legal entities individually – e.g., bank, insurance company, securities firm and asset manager, etc., though group level governance is covered by regulation as noted below.

131. Emphasis should be increased on the roles of group-wide internal audit and the group board's audit committee, including direct assessments of group-level audit effectiveness. For instance, supervisory coverage on internal audit at banks is typically part of the CAMEL-R assessment process and the comprehensive examinations. In addition, supervisors may review bank-level internal audit work as part of a targeted or thematic review. The FSS does not make an explicit assessment of whether internal audit can be relied upon to cover prudential issues; the FSS makes these assessments itself.

132. As noted above, the FSS should work to enhance its capacity to take a more forward-looking perspective in assessments of the quality of banks' risk management practices. Current practices are largely reactive to issues and events that are captured through offsite monitoring or carried out as part of the periodic comprehensive exams. A review of Board minutes and reporting is a core element of the onsite review. The process to confirm that a Board and senior management remain effectively engaged and informed of the changing risk profile of the bank and take appropriate action does not appear well developed.

133. There should be more emphasis by the FSC/FSS on corporate governance to embed better corporate governance standards and practices in the capital market. The area of corporate governance has received attention from the policymakers in Korea. Regulations on Supervision of Corporate Governance of Financial Companies and the CGA governs the corporate governance of capital market entities and other financial institutions supplemented by provisions in the CA.

134. As part of the overall efforts to strengthen corporate governance, there must be greater accountability placed on boards and senior managers which could include putting in place a senior managers regime of the type that exists in several developed markets. There must also be higher levels of supervisory engagements with the boards and senior managers. While there are some elements of this that exist in Korea, the discussions with the supervisors indicate that there is still significant room for improvement. An elevation of the overall efforts in respect of addressing governance and culture at firms as well as levels of engagements and accountability being placed on boards and senior managers in the regulatory and supervisory approach adopted is needed. At the heart of every major crisis in financial markets there is an element of governance failure. Strengthening governance, culture and conduct must appear more deeply in the supervisory philosophy adopted.

135. A dialogue between supervisors and external auditors should be intensified. Currently, supervisors do not meet regularly external auditors to discuss their findings. It is good practice to meet auditors at least annually. For systematically important or troubled institutions, it is also recommended to meet external auditors in a preparatory phase. The results of auditors should be regularly reviewed by supervisors, and in the case of failures, enforcement actions should be taken against respective auditors (and partners of audit firms). A relationship should be also established with professional association of auditors, to communicate expectations of supervisors.

Banks

136. Well-developed practices for FSS monitoring of bank compliance with laws and rules, benefit from a generally strong regulatory framework for banks. The approach makes extensive use of continuous offsite monitoring, which provides for a comprehensive process for assessing compliance with rules and laws. Follow-up assessments through examination activities are carried where deemed warranted, which may be the result of a firm failing to comply with requirements or other issues identified through the monitoring process. In addition, each bank is in practice subject to a periodic comprehensive examination every 2-3 years, depending on size.

137. The FSS' banking supervision approach appropriately includes extensive use of offsite monitoring of compliance with laws and regulations. This involves monitoring for compliance with regulatory limits and minimum requirements, as well as continuous monitoring of business activities and associated risk profiles. Offsite supervision includes a variety of processes for monitoring firm-specific performance and financial condition, as well as the operating environment and macro-economic or systemic developments. Supervised firms are required to report on a variety of indicators of compliance with requirements; supervisors review and assess these reports and determine if follow up, including via examinations, is warranted.

138. For banks, the supervisory assessment is built on the CAMEL-R framework and the supervision process focuses primarily on traditional assessments of CAMEL factors and a Risk Assessment at the bank level. The CAMEL-R rating includes both quantitative and qualitative factors. The CAMEL ratings are updated biannually as a result of the comprehensive exams. The quantitative elements of the Risk Assessment are carried out annually, with qualitative factors assessed during onsite exams as warranted in the biannual exam based on a comprehensive planning process. Qualitative factors are largely assessed through the use of manuals and checklists for risk management and control practices used by onsite examiners.

139. The CAMEL-R assessment is used to determine the level of supervisory scrutiny and help identify areas that warrant supervisory attention. However, other than increased scrutiny, there are no binding restrictions driven by the rating process such as exist in other jurisdictions. While this may give the FSS flexibility, it undermines the use of the rating to serve as a strong incentive for banks to address any failures to meet supervisory expectations, including with respect to key risk management and controls weaknesses.

140. As noted, the FSS has been increasing the share of work carried out through on-site supervision in line with the previous FSAP recommendations, but the balance still tilts toward monitoring against rules-based requirements. There is no requirement to carry out periodic “comprehensive onsite examinations”. In practice, however, the large banks and DSIBs are subject to these reviews biannually, while the smaller banks are generally examined every three years. The comprehensive examinations are risk-focused and cover a reasonably broad swath of banks’ risk management and internal controls processes, as well as consumer compliance and protection areas.

141. The current mission continues to find that the FSS could enhance its effectiveness by increasing the intensity of supervision, particularly for the D-SIBs, as the previous FSAP recommended. The extensive rules-based requirements and reporting against these by the banks provides a strong base from which to assess the firms. However, it does not necessarily encapsulate the type of qualitative evaluations that are critical for informing meaningful assessments of SIB groups. For those firms deemed to represent systemic risk to the Korean economy and financial system, more resources should be spent carrying out analyses and examinations, as well as in communicating the need for these banks to meet the highest standards and rapidly address any material prudential weaknesses.

142. Notably, the value of a Pillar 2 add-on process for banking groups that already hold capital in excess of regulatory minima is limited in its ability to provide an incentive to address the underlying weaknesses resulting in the add on charge. This has not been recently tested as supervisors are still refining respective processes to calculate a Pillar 2 add on and it has not been used. A Pillar 2 assessment could be a more significant part of the supervisory process if framed by a formal annual supervisory review process, at least for large banks, as done in some other jurisdictions. This formalization would foster greater the structure of the supervisory process, increase transparency for banks, and also provide an opportunity to support supervisory views on risk management challenges at the firms. The outcomes of these review should articulate qualitative and quantitative assessments. Although, banks are perhaps well above potential minimums, their position would be different, if decisions about capital levels would be limited by supervision requirements.

143. The strength of Korea’s capital requirements is tempered by reliance on internal models-based approaches to risk-weighted asset (RWA) calculation combined with a leverage ratio backstop. While it should be noted that the RWA/Total Asset density of Korean banks is not as low as some other jurisdictions, the use of the leverage ratio as a backstop to an internal ratings-based (IRB) approach does create conflicting incentives for banks. On the one hand, banks may increase their holdings of risky assets to maximize returns relative to the leverage ratio constraint, while at the same time seeking to minimize the contribution of these positions to RWA calculations using their internal models. This increases the importance of supervisory reviews of firms’ modeling approaches, as well as in-depth reviews of the risk measurement practices and controls around both the identification of risks and the data used to report those risks. A particular area of focus for FSS supervisors should be risk identification and D-SIBs group-wide capacity to capture and report all

risks across the group to ensure the comprehensiveness of the risks captured in models used for RWA calculations and for internal and FSS stress testing.

144. The FSS should increase the importance placed on stress testing for assessing capital adequacy. This should include both top down and bottom up stress tests run by the banks and FSS. While the current approach gives some attention to stress testing practices and results, that weighting should be increased, and strong consideration should be given to requiring D-SIB groups to meet post-stress minimum capital thresholds. In addition, internal stress tests run by banking groups for ICAAP and capital planning purposes should face greater supervisory scrutiny and serve as a key window into FSS assessments of risk management and internal controls at these firms.

145. Comprehensive off-site analyses of group level liquidity will benefit from implementing LCR or NSFR requirement at the holding company level. Additional data about relevant cash-flows among entities within banking groups could assist in identifying important inter-group dynamics and the roles of various subsidiaries, which will benefit both day-to-day supervision monitoring in crisis situations.

146. Supervision of liquidity risk management is focused on the bank level for all commercial banks. A key aspect of supervising liquidity risk management is offsite monitoring of liquidity positions on a bank consolidated basis using required regulatory reports on all limits and restrictions. The monitoring process includes reviewing banks' 'Business Reports', monitoring market indicators and banks' internal early warning systems for liquidity risk. Banks are required to submit data in the form of Business Reports for calculation of regulatory liquidity requirements such as LCR, FX LCR, loan-to-deposit ratios (denominated in KRW), FX liquidity ratios, and the NSFR. FSS supervisors also receive data on contractual maturity mismatches, concentrations of funding, and available unencumbered assets in the form of Business Reports.

147. Qualitative assessments of liquidity risk management would be carried out as part of the onsite examination process, primarily through the biannual 'comprehensive examinations', should the planning process find that a focus on liquidity is warranted. Examiners are provided with check lists for the assessment of qualitative factors to support their assessments. Such an examination would focus on key aspects of liquidity risk management, measurement and compliance with limits, key inputs into required stress tests, etc. Between biannual comprehensive exams, supervisors receive quantitative data on a quarterly (and often more frequent) basis for liquidity, as noted above.

148. The primary efforts to assess risk management is the annual risk assessment process and the biannual comprehensive examination used to develop the CAMEL-R rating. As noted above, the FSS also increasingly uses thematic and targeted reviews to assess specific practices and/or activities deemed to warrant follow up.

ODIs

149. The supervisory approach for MSBs and MCCs, including supervisory and enforcement tools, contain all important elements.

Off-site supervision monitors various indicators on a frequent basis and performs regular CAEL assessments, using business and regulatory reports. The outcomes of supervisory assessments are used for prompt corrective actions, such as MIR, MID and MIO. The FSC/FSS has sufficient powers also towards national federations of mutual cooperatives. The composite ratings of the assessments (CAMEL) are calculated by examination departments, using information from on-site inspections. The FSS may also request auditors of MSBs to submit information for the purpose of supervision. The FSS holds no power to make a similar request in the case of MCCs, which represents one of the gaps of the current framework.

150. ICAAP or ILAAP are not part of the framework of either MSBs or MCCs. With the modernization of the regulatory framework, ICAAP and Pillar 2 should be considered for MSBs.

151. Although the sector of MSBs has gone through the gradual process of stabilization, it still requires a close attention of supervisors.

Since 2011, MSBs have experienced a wave of restructuring, followed by tightening of regulatory standards and continuous improvement of the indicators of financial soundness. Their business model is primarily oriented on unbanked or financially underserved individuals and small businesses with a higher risk profile. For that reason, supervisors are encouraged to continue the implementation of more stringent requirements fostering the capital and liquidity position of these institutions, followed by diligent supervision and strong enforcement—all anchored by a strategic supervisory plan. Supervision should consider changes in the business environment influenced by new technologies, impacting the customer base of some MSBs.

152. Several MSBs are members of financial conglomerates, including NFGs. Although, their balance sheets are currently relatively small, comparing to the overall financial groups' balance sheets, their growth is quite substantial and their position in the groups can become more significant (also, thanks to benefiting from a less stringent framework). It will require supervisors to align their approaches with supervision of other institutions, primarily with banks. A special attention will be required by MSBs which are members of NFGs, where regulatory framework is less efficient.

153. Volatile market conditions can also create new challenges to MCCs, which may require well-orchestrated responses from the currently fragmented group of multiple supervisors.

Credit cooperatives play an important role in the Korean financial system representing more than 16 percent of the total assets of deposit taking institution and serve primarily or exclusively some communities. This increases pressures on supervisors in taking well targeted, effective actions. To succeed, all institutions mandated by regulation and supervision of MCCs must cooperate closely. In the current institutional arrangements, it can pose certain challenges. In the context of potential pressures on MCCs, preventing contagion spreading to financial groups from related MCCs creates additional demands on supervision. This is another argument why the supervisory system needs a firmer guidance by the FSC/FSS. MCCs do not belong to any financial group as they are independent legal entities with a diversified shareholders structure.

Insurance

154. As in banking, the insurance supervisory approach remains largely rules based. The FSS supervises the soundness of insurance companies by evaluating their business operations and risks through the RAAS, a supervisory evaluation and rating regime which comprises a qualitative and quantitative evaluation. A quantitative evaluation of the components is conducted quarterly or ad-hoc if deemed necessary, while qualitative evaluations are conducted during on-site examinations.

155. RAAS involves an analysis of management risk, insurance risk, interest rate risk, investment risk, liquidity risk, capital adequacy, and earnings. RAAS consists of quantitative and non-quantitative factors, and the quantitative factors have 17 assessment indices. The FSS also utilizes business reports that insurance companies submitted to the FSS quarterly. The FSS applies different weights to evaluation components in consideration of the different risk nature between life and non-life companies and differences in business characteristics. Depending on business characteristics, some components may be excluded from evaluation.

156. The examination cycle is, to a large degree, determined by the RAAS score of each undertaking. The FSC and FSS have determined four categories of supervisory intensity: (i) autonomous, (ii) regular, (iii) intensive, and (iv) emergency. According to the category, the examination cycle ranges from every three to four years for autonomous monitoring to every one to two years for intensive monitoring. Companies falling in the emergency category are deemed to be examined immediately.

157. The FSS reviews the adequacy of insurance companies' risk management process and financial conditions based on ORSA results submitted by them. In addition, the FSS may request insurance companies to submit materials detailing the calculation methods for risks used in the ORSA. The adequacy of an ORSA is reviewed during the RAAS evaluation and may result in requests to strengthen risk management or capital adequacy.

158. Insurance companies are required to conduct stress test for major risks at least semiannually and comprehensive stress testing at least annually. The FSC/FSS develops scenarios for different risk factors depending on macroeconomic and financial market indicators. Stress test outcomes are reviewed by the FSS at least once a year. The scope of the tests extends to the impact on the balance sheets, income statements, RBC ratios, and liquidity. The time horizon for the stress tests is set in accordance with the expected duration of the stress, the risk characteristics of assets and liabilities, but it is usually set at a year or longer. At a minimum, insurance companies must include their insurance risk, interest rate risk, market risk, credit risk, operational risk, and liquidity risk. When conducting comprehensive stress tests, insurance companies are required to consider the diversification impact arising from the correlation of risk factors and provide to the FSS appropriate explanation and rationale for such correlations.

159. The FSAP considers a higher supervisory intensity and a more forward-looking perspective imperative. Aging, the low-yield environment and intense competition will shape the insurance sector for the years to come. This requires an intensified supervisory focus on companies'

business models and risk management practices. The FSS should therefore exploit the full potential of the ORSA and incentivize an earlier implementation by all insurance companies. Furthermore, the FSS should deepen its risk dialogue with companies' senior management and internal control functions. Aggregated findings from this dialogue should also feed into macroprudential surveillance and horizontal analysis of the sector.

160. Like in banking, supervision must step up its focus on corporate governance, and the supervision of overseas insurer activities. Insurers' corporate governance needs to be strengthened further and Boards of Directors held accountable. The FSS should consider more forward-looking and qualitative components in the RAAS process (incl. changes to business models). While overseas operations are small compared to domestic business in Korea, growth rates are considerable and, concentrated in a few markets, Korean insurers hold non-negligible market shares. Closer and intensified monitoring of overseas expansion, further strengthening working level cooperation with host authorities, and setting up supervisory colleges are some of the other desired actions.

Asset Managers and CIS

161. There is a need to enhance the supervision of the asset management industry with a more comprehensive and frequent inspection program. In light of the significant deregulation of the private funds' markets and the growth of smaller asset managers, including hedge funds, the authorities should enhance their supervisory efforts including an expanded program of on-site examinations. There needs to be also a greater focus on mis-selling and misconducts risks in light of recent experiences. Additionally, investment products are seen by financial groups as business lines with a substantial growth potential, and similar cases could have implications for larger institutions as well.

162. Instances of mis-selling and misconduct have begun to rise and may pose reputational risk for financial conglomerates. With elderly households and younger Koreans seeking 'higher yields', this practices could impact market confidence, if risks related to severe redemption and liquidity pressures in the funds and asset management industry are not recognized sufficiently. The processes to monitor systemic risk should continue to further acknowledge the increasing potential for systemic risk arising from the securities sector, while certain deficiencies in the regulators' arrangements to manage defaults should be taken into account.

163. Misconduct and mis-selling concerns have already been the subject of investigation by the authorities, including within large financial institutions, following some highly publicized and damaging losses associated with the equity linked securities (ELS) and derivative linked securities (DLS) products sold by several securities firms. In an environment of investor fragility, loss in confidence and pressures to manage growing demands on retirement savings for an aging society any major misconduct or governance failure can have significant long-term damage to investor psyche with consequential systemic effects across the markets.

164. The FSC/FSS has received filed complaints alleging that the institutions selling DLS and related products were doing so in an “irresponsible” manner with mis-selling being alleged.

The matter has received widespread attention in the media and marketplace. The financial authorities have been conducting their investigations to look into the matter to determine how the products were designed and sold to the clients.

165. The experience with DLS/Derivative Linked Funds (DLFs) clearly shows how misconduct risks can damage the trust and confidence of investors and undermine the efforts that are being made to grow the Korean capital markets.

While taking the appropriate enforcements actions against those responsible would be critical to send a strong signal of credible deterrence, it is equally important for the authorities to look at how the supervisory efforts against misconduct risks can be enhanced, including an assessment of the underlying culture within the firm and the role of the firms and their boards and senior managers, in ensuring that there are internal governance arrangements, controls and appropriate incentive structures to prevent these sorts of problems from damaging investor confidence.⁶⁶

166. What could the Korean authorities do about this to avoid any unintended and reputational and investor protection spillovers?

- **First, the authorities should fully implement the key IOSCO MMF recommendations.**⁶⁷ Ensuring that MMF fund valuations adopt fair value and are marked to market is important and should be in place expediently. The authorities should consider putting in place properly structured stress tests to be conducted on the asset management industry with clearly defined parameters on size and type of funds which is particularly important for MMF funds.
- **Second, stronger surveillance of capital market risks accompanied with a more regular inspection program.** Market surveillance should cover both off-site monitoring and thematic assessments. Frequency of on-site inspections should be scaled up along with external audits for entities which may in isolation appear relatively small but could pose risks to the integrity of the markets.
- **Third, develop a systemic risk framework that incorporates the securities sector.** This could be done as a joint exercise with other parts of the FSS and the BoK to better capture cross sectional and macro financial risks emanating from the securities market. Conduct stress tests on the asset management industry with clearly defined parameters on size and type of funds, particularly for MMF funds.

⁶⁶ In response, an amendment to the Act on Corporate Governance of Financial Companies is currently in the process. The amendment requires senior managers to verify whether the internal governance arrangements are operational and whether they are followed by the staff. The authorities may take an enforcement action against senior managers failing to meet this requirement. The amendment is pending in the Parliament.

⁶⁷ The recommendation is based on the regulation effective by June 30, 2019. Shortly before the publication of this note, legal changes requiring the market-value assessment and stress testing of institutional MMFs were adopted.

- **Finally, implement an integrated approach to supervision, focusing on products offered across the financial system.** The products are often distributed by multiple types of financial institutions (distribution channels), where an appropriate supervisory framework is not in place. The FSC/FSS should take an initiative to close these gaps.⁶⁸

D. Cross-Border Activities

167. The FSC/FSS has entered into Memorandum of Understanding (MOUs) with financial authorities of jurisdictions relevant for cooperation in supervision of Korean financial groups.

For the banking sector, MOUs with 25 jurisdictions on information sharing and supervisory cooperation have been signed. The FSC/FSS has also concluded MOUs in 19 jurisdictions for supervisory cooperation and exchange of information on cross-border insurance companies. These MOUs provide for exchange of information concerning supervision of globally operating financial institutions, high-level and working-level meetings, and group-wide supervision. The FSC/FSS signed an MOU related to the Alternative Investment Fund Managers Directive with 27 jurisdictions that are members of the European Securities and Markets Authority (ESMA) in July 2014 and June 2015. In March 2019, the FSC/FSS signed an MOU with the U.K. FCA in anticipation of the likelihood that the U.K. will no longer be part of ESMA after Brexit. The MOU with the U.K. FCA is nearly identical to the MOU that the FSC/FSS signed with ESMA jurisdictions.

168. The FSC also submitted an amendment to the FSCMA for the adoption of the Asia Region Funds Passport (ARFP) to the National Assembly after the FSC/FSS signed a memorandum of cooperation with four other ARFP participating economies—Japan, Australia, New Zealand, and Thailand—in April 2016. When implemented, the ARFP will provide a multilaterally agreed framework that streamlines the registration process for offshore funds and facilitate cross-border marketing of managed funds across the participating economies. However, fund managers and funds originating from ARFP participating economies also have to meet foreign fund manager qualifications and foreign fund requirements. In order for an offshore fund manager to operate in Korea, it has to have a certain size of AUM and meet the minimum capital requirement. To market or sell an offshore fund, the manager must have established the fund in the countries stipulated in the FSCMA with expressly stated information on commissions and fees. However, it is not clear what the appetite is within the industry to participate actively in the ARFP or the impact this will have on the Korean asset management industry. In discussions with the industry there seems to be either a lack of awareness about this initiative or at best a lack of reaction to the proposal and the FSC/FSS should engage more widely with the industry to raise awareness of both the impact and opportunities associated with the ARFP.

169. Given large Korean financial institutions plan to continue expanding overseas operations, the cross-border supervisory activities would benefit from a wider variety of forms of cooperation. The FSC/FSS perform regular examinations of foreign branches and

⁶⁸ According to the update by the FSC/FSS before the publication of this Note, the Authorities have taken a number of steps, including restructuring of the FSS organization, changes to the Act on Financial Consumer Protection, and elaborating the regulation on business conduct for high-risk financial investment instruments.

subsidiaries of financial institutions. Also, visiting programs and conferences are organized for foreign supervisors. Lastly, the FSS engages in capacity building with host authorities, in particular in South-East Asia. However, given the number of countries, where the Korean financial institutions are present, more institutionalized form of cooperation should be considered—specifically, colleges for major Korean groups with significant foreign operations should be established. As a host supervisor, the FSC/FSS participates in supervisory colleges for major global financial groups.

E. Climate Risk

170. The awareness of climate risk is swiftly picking up in Korea, but individual initiatives should be steered by a stronger institutionalized framework to better address emerging risks by policy actions. Korea has taken several actions across the financial system. The first ESG foreign currency bonds were issued in 2013, while the first KRW ESG bonds, marking an interest in this kind of asset in the domestic market, were issued in 2018. This trend continued in 2019, when Korea has reportedly become a large supplier of such bonds, with 16 percent of the global market share. The bonds are issued by the government related entities, but also by large financial institutions. Large banks and financial groups have subscribed to the ESG principles and started organizing The Sustainable Climate Finance Forum in Korea. However, the National Pension system (NPS), as the largest domestic investor, is still in the process of developing criteria for ESG investing after having adopted principles on responsible investments in 2018.

171. The BOK joined the Network for Greening the Financial System (NGFS) in 2019, and other authorities are considering memberships. All this development evidence an active approach across Korean institutions. However, it would benefit from firmer steering from side of the Authorities responsible for the financial system oversight. Their leading role in a forum for coordination would help to formulate policy actions, framed by a clear strategy. This could help to comprehensively address emerging risks in the area and to prevent uncoordinated actions.

172. The FSC/FSS is taking a focus on climate risk in the recent survey, as well as the BoK in its stress tests, however a comprehensive action plan following the findings is still pending. The FCS/FSS has organized a survey across financial institutions on climate risks and intends to carry out a comprehensive analysis of the impact of climate-related financial risks on Korea's economy and finance sectors to identify any vulnerability. Similarly, the BoK announced stress test results in its Climate Change and Financial Stability report in June 2018. All these valuable inputs should be summarized in a comprehensive action plan for the financial system, coordinated by the FSC/FSS/BOK, opening a path to systematic work on concrete measures taken in coordinated manner.

173. For banks transition risk imported from overseas seems to take importance while in insurance, physical risk is starting to be apparent in the books of institutions. Not only Korean large corporates, but also SMEs, are dependent on exports to jurisdictions that are taking steps to restructure their economies to be more sustainable. This will result in changes in their demand for environmentally sensitive products, which require new technologies and strategies on side of Korean exporters. Currently, this appears to be the main channel of transitional risk for banks and ODIs. But

also, the Korean Government by adopting new strategies to make local oriented business, including construction or agriculture, more sustainable might create new challenges for financial institutions, primarily banks and ODIs.

174. Insurers face moderate risks from higher frequency and severity of natural disasters.

Korea is moderately exposed to typhoons, located at the periphery of the Pacific typhoon region, and occasionally snowfalls which cause damage to households, corporates and infrastructure, but only a relatively small amount of losses is borne by the (re)insurance sector. The government provides coverage for those uninsured, particularly in agriculture. While the 2019 Pacific typhoon season has set a new record in economic losses, the effects on Korea were limited, with typhoon “Lingling” being the costliest event and the fifth strongest since 1959—still the economic loss amounted to less than USD 300 million.

175. The disclosure of carbon emissions of listed companies is well established, but the specific disclosures of climate related strategies and investments of financial institutions is still work in progress. All listed companies—including financial institutions and their groups—are obliged to periodically disclose business reports that include analyses of environment-related matters. A company classified as a controlled entity under the Framework Act of Low Carbon Green Growth is required to include its carbon emissions and energy usage. The framework prepared by the Financial Stability Board (FSB) Task Force on Climate-related Financial Disclosures should be reflected in sustainable management reports. However, there are no measures in place to enforce financial institutions to report climate-related financial risks to the financial authorities, as the legislation requiring financial companies to include matters related to corporate social responsibility (including environmental protection plans) in their business reports is pending in the National Assembly. A unified taxonomy defining “green” or “brown” assets is currently not in the center of discussions of the Authorities and there may be data gaps on side of financial institutions to implement such taxonomy. However, the FSC/FSS is taking steps to establish a disclosure system that would be designed to efficiently collect and disclose climate change-related corporate information.

Appendix I. Supporting Measures

(to be used along with Table 1 - Main Recommendations)

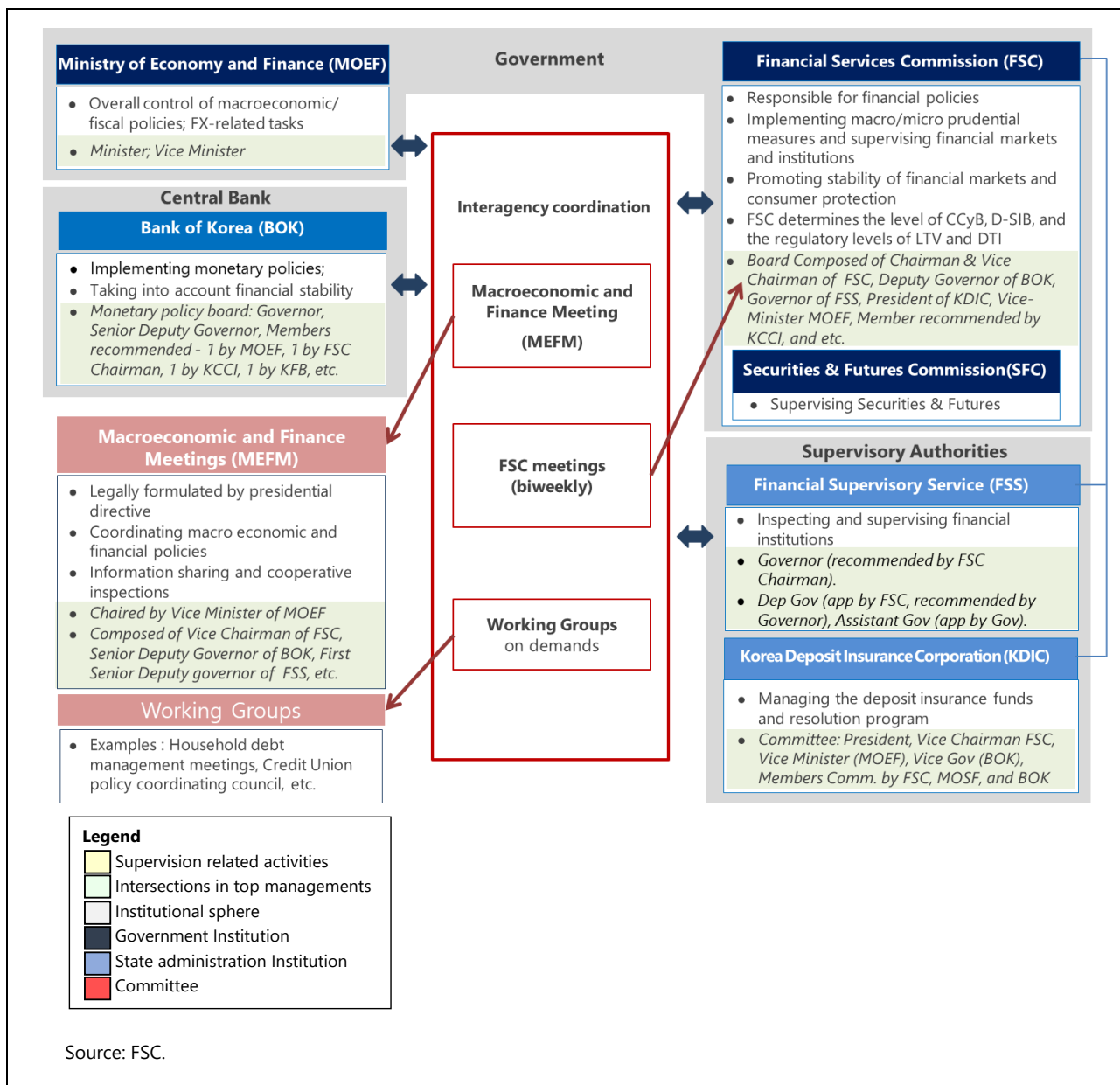
Measures	Para #	Timing
<i>Preconditions for Effective Conglomerate Supervision</i>		
1. Strengthen the effectiveness of supervision and the efficiency of supervisory processes by <ul style="list-style-type: none"> • establishing pre-conditions for the implementation of long-term strategy, through extending the term of the FSC and the FSS top representatives • ensuring unconstrained access to resources (subject to the accountability), through modifying the roles of the FSC/FSS in the budgetary process: the FSC should delegate general budgetary principles and oversee the use of the budget; the FSS should apply these principles, endorse and execute its budget; it includes the system of the examiners' salary levels, consistent in time, which are benchmarked to the industry levels • rearranging the enforcement process • fostering regulatory processes, through implementing supervisory guidelines issued by the FSS • clearly prioritizing supervisory goals, especially the goal of the stability and soundness of the financial system, vis-à-vis developmental goals of the Government. 	25-31; 35	LT
2. Strengthen information sharing and coordination of activities across supervisors responsible for subsidiaries in different sectors – e.g., banks, securities firms, insurance, etc. – by building out capacity of 'group supervision teams' and 'supervision coordination departments' for conduct and prudential supervision.	33, 120, 122, 125	ST
<i>Conglomerate Regulatory and Supervisory Framework</i>		
3. Broaden definition of financial holding company (FHC) by introducing additional criteria, and greater discretionary powers of FSC/FSS.	45	MT
4. Establish a capital framework for "non-holding financial groups" with large financial institutions, capturing relevant risks including a potential contagion from a wider-group; group wide risk assessment and risk surcharge (primarily capturing concentration risk and contagion risk) should reflect the intra-group transactions and the overall corporate governance of the group, including its size and the complexity, incentivizing groups to streamline their structures.	52-55	MT
5. Establish the obligation of group-wide external auditors or its equivalent. Enhance the use of external auditors to support supervision, by expanding their mandates and obligations. Define approval process of auditors.	112, 135	MT
<i>Conglomerate Supervisory Practices</i>		

Measures	Para #	Timing
6. For large banking groups, continue enhancing the supervision of risk management and internal controls by further upgrading periodic in-depth examinations of key bank and group practices, such as ICAAP and capital planning, ILAAP and Credit Risk Management and use the findings to inform assessments of risk management and controls at both levels.	126-134	MT
7. Increase the supervisory intensity of insurers with a focus on risk management and corporate governance, and in the context of the Korea Insurance Capital Standard (K-ICS) implementation verify long-term viability of insurers' business models, financial strength of major shareholders, and need for capital injections.	88	ST
8. Deepen the regular risk dialogue with insurers' senior management and internal control functions and incentivize earlier ORSA implementation at all insurers.	159	ST
9. Increase focus on the role of internal audit as the eyes and ears of the Board of Directors (BoD) to increase confidence the BoD is well informed of the strengths and weaknesses of key practices that support their decision making regarding, for example, capital and liquidity needs at consolidated holding company level and at major subsidiaries.	126, 131	MT
10. Require sign off by group-level chief auditor or BoD audit committee when closing out remediation of material weaknesses noted by supervisors. For weaknesses in critical prudential practices this should include a cure period during which the remediation can be shown to have worked as the firm expected.	112, 135	MT
<p>11. Enhance the supervision of credit risk management by periodically carrying out more in-depth examinations of key qualitative elements of enterprise-wide credit risk management. Such a review should cover all parts of the FHC group that have material exposures to credit risk, including any credit risk present in loan books, investment portfolios, trading counterparty relationships, private equity investments, sponsored real estate trusts, etc.</p> <ul style="list-style-type: none"> • Elements of this review could be drawn from categories currently required to be reported by banks' in the annual 'credit risk self-assessment' and should include a periodic assessment of the group-wide credit review function. • Assess the effectiveness of FHC senior management in overseeing firm-wide credit risk management. • Assess the effectiveness of FHC Risk Committee and Audit Committee with respect to credit risk management. 	110, 116, 119	MT

Measures	Para #	Timing
<p>12. For large banking groups, enhance the supervision of liquidity risk management by carrying out more in-depth reviews of liquidity risk management at the group level on a periodic basis; at least every two years.</p> <p>Such reviews should consider:</p> <ul style="list-style-type: none"> the data/information quality and timeliness of internal reports used to manage liquidity risk at the group and major subsidiaries; the quality and timeliness of data/information provided in the regulatory reports used for offsite liquidity monitoring; the comprehensiveness of coverage of group-wide liquidity risks, including with respect to intraday funding; internal liquidity risk stress testing at the group level; and group level contingency funding plans. 	129, 146, 149	MT
<p>13. Incorporate the principle of proportionality into prudential supervisory expectations and requirements for banking organizations and NBDIs. Requirements and expectations for systemically important FHCs should be stronger in all prudential areas than for smaller firms.</p> <ul style="list-style-type: none"> Ensure appropriate minimum prudential requirements for depository institutions and related holding companies based on systemic importance. Increase supervisory intensity for DSIBs relative to other banking groups. 	126	MT
<p>14. Strengthen corporate governance requirements with higher levels of supervisory engagement with the boards and senior managers regarding their responsibility to oversee execution of approved risk-management framework and internal controls practices on an enterprise and a group wide level:</p> <ul style="list-style-type: none"> For assessments of corporate governance at the group level, increase focus on assessing BoD effectiveness with respect to its responsibility to oversee execution of the BoD approved risk-management framework and internal controls practices. Incorporate an assessment of the BoD and management effectiveness in supervisory ratings at group level rather than as part of Risk Management in the CAMEL-R bank rating framework. Better link assessments of the BoD and senior management effectiveness to underlying assessments at the sectoral level. For example, if there are risk management and control weaknesses identified by supervisors at the securities firm subsidiary, this should directly inform the assessment of the FHC Risk Committee. 	39, 58-61, 111, 130-135, 160, 165	MT
Sectoral and Supporting Actions		
<p>15. Carefully design the capital charge for longevity risks under K-ICS, not only relying on historic experience, but also projecting changing policyholder behavior in a society facing an adverse demographic shift (lower lapse rates, higher preference for annuities instead of lump-sums).</p>	88	ST
<p>16. Explore legal options for dealing with the legacy business of life insurers, incl. portfolio transfers, run-off entities, financial reinsurance, and conversion offers to policyholders.</p>	88	ST

Measures	Para #	Timing
17. In the context of K-ICS, consider the legal possibility of Pillar 2 capital add-ons for insurers whose risk profile deviates from the standard assumptions of the K-ICS calibration.	88	ST

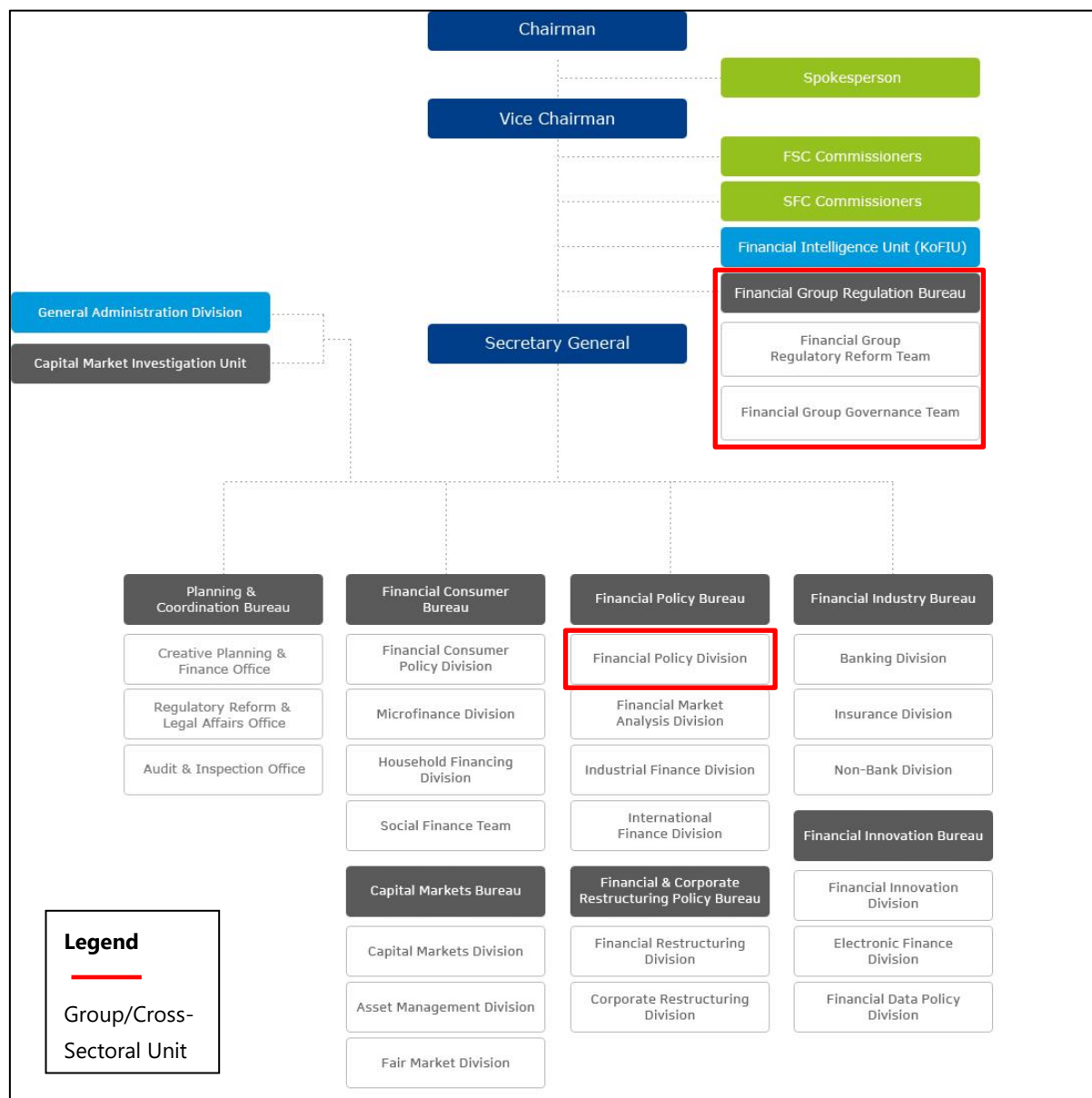
Appendix II. Map of Financial Sector Oversight Structure



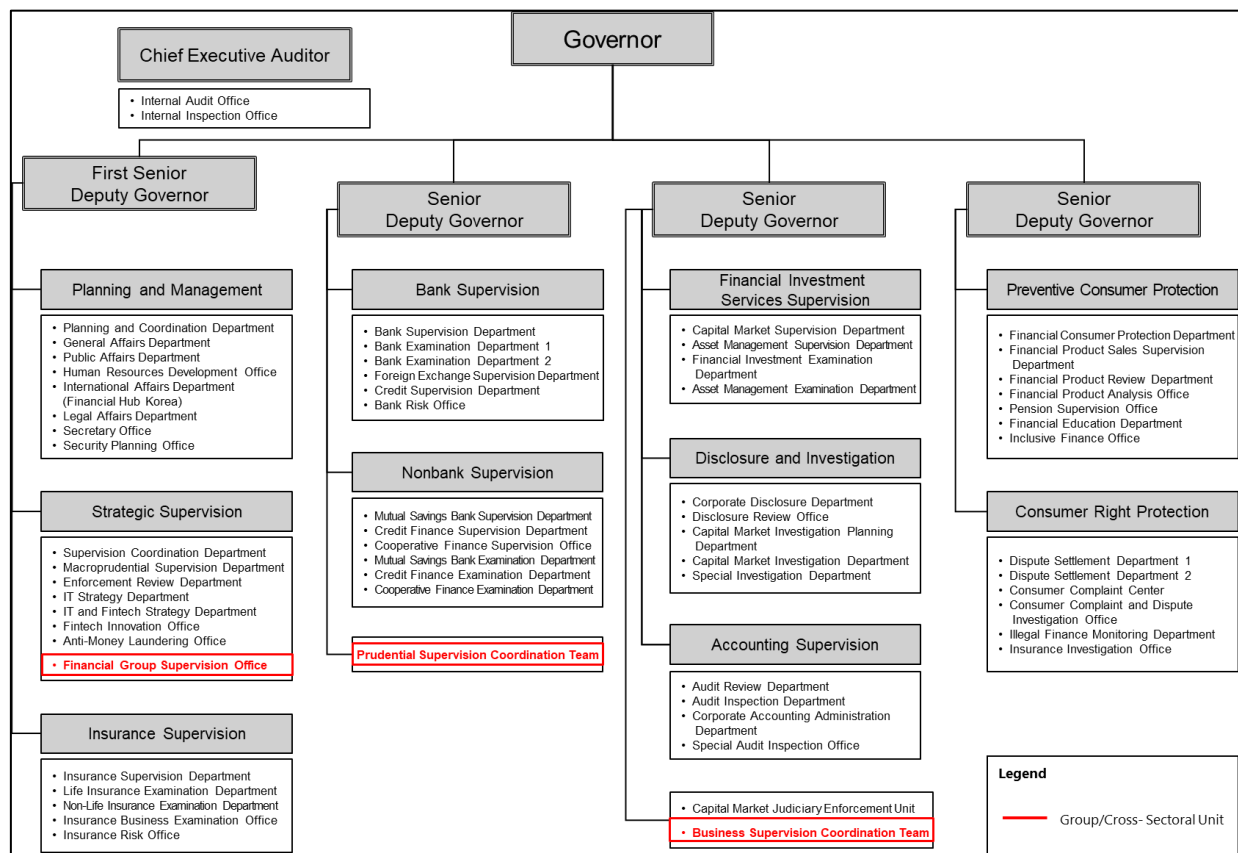
Appendix III. Institutional Architecture of Deposit Taking Institutions' Supervision

Subject		Chartering and Licensing Authority	Prudential Regulator	Prudential Supervisor	Inspecting Authority
Banks		FSC		FSS	
Mutual Savings Banks					
Mutual Credit Cooperatives	Credit Unions	FSC		FSS and national federations	National federations (supplemented by annual inspections of FSS)
	Agricultural Cooperatives				
	Fisheries Cooperatives	Ministry of Oceans and Fisheries			
	Forestry Cooperatives	Korea Forest Service			
	Community Credit Cooperatives	Ministry of the Interior and Safety	Ministry of the Interior and Safety and their national federations		National federations, on request assisted by FSS (also supplemented by annual inspections of FSS)

Appendix IV. Organization Chart of FSC with Focus on Group/Cross-Sectoral Regulation

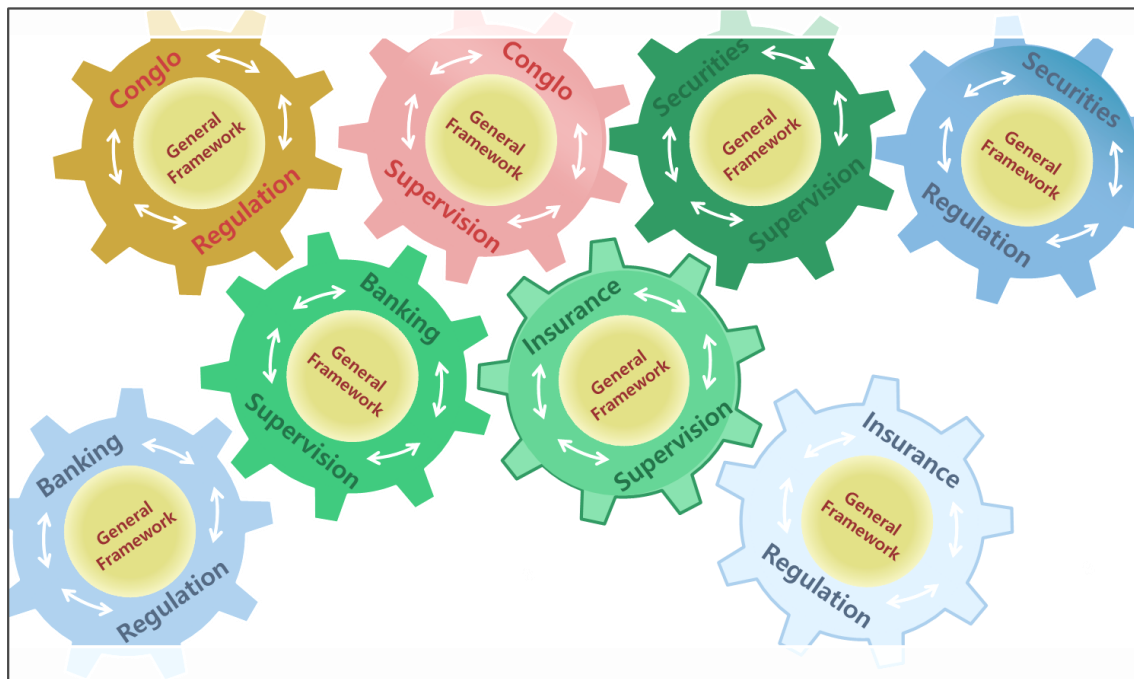


Appendix V. Organization Chart of FSS with Focus on Group/Cross-Sectoral Supervision

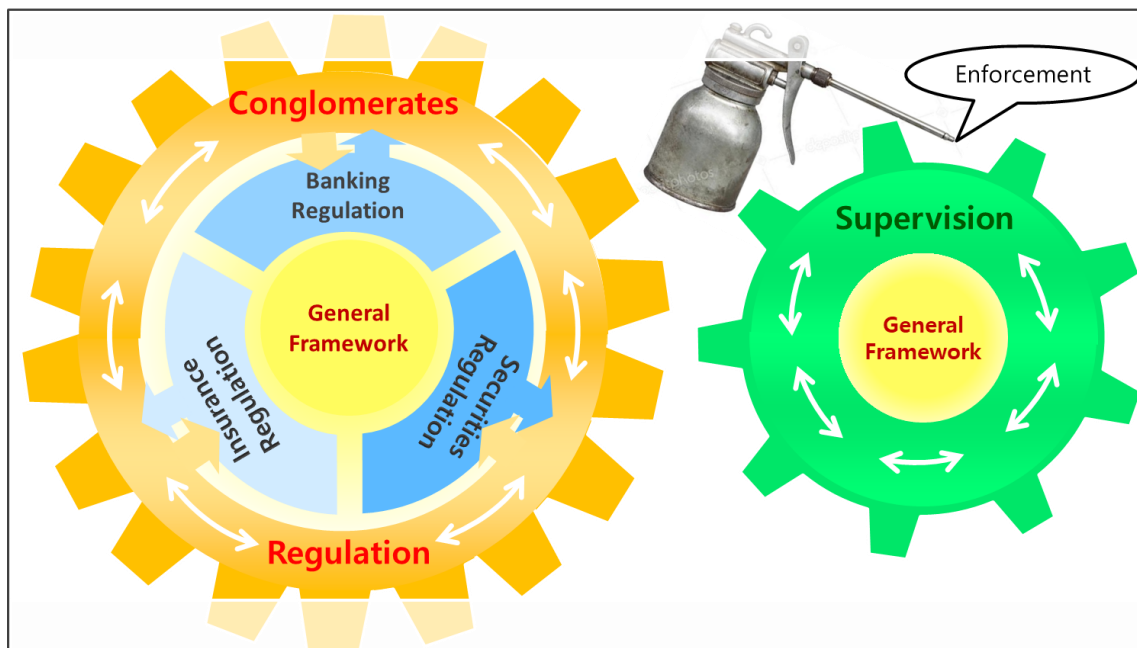


Appendix VI. Models of Organization of Sectoral Supervisory Activities

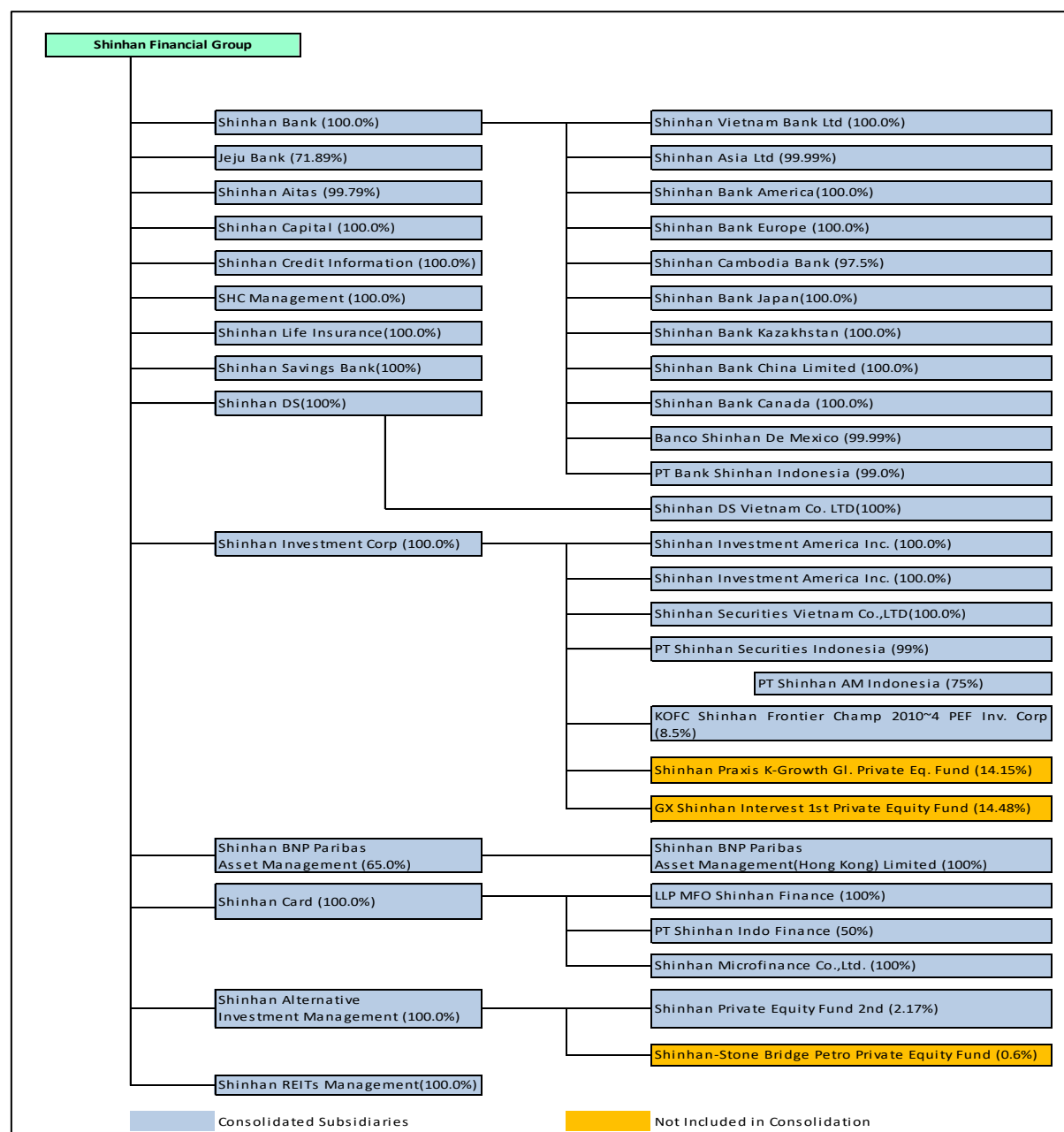
An illustrative figure of sectoral activity silos in supervision.



An illustrative figure of integrated approach to supervision.



Appendix VII. Illustrative Example of Holding Financial Group Map



Source: Shinhan Financial Group

Appendix VIII. Overview of Financial Conglomerates (2019)

Classification	Name
BG (13)	9 BGs with a bank holding company including Shinhan, KB, Nonghyup, Hana, Woori, BNK, DGB, Korea Investment, and JB 4 BGs with a bank as a parent company IBK, KDB, SC, and Citi Bank
MXG (26)	26 MXGs including Samsung, Hanwha, Kyobo, Mirae Asset, Hyundai Motor, DB, Hyundai Marine & Fire Insurance, Taekwang, MBK Partners, Lotte, Daishin Securities, Daou Kiwoom, Eugene, Well to Sea Investment, Orix, Daehan Real Estate Trust, KTB Investment & Securities, The-K Non-Life Insurance, Shinan, MDM Plus, Pureun, Must, Hyundai, Synergy, AJ Networks, and Hwasung
FC (5)	1 FC with a non-bank holding company (insurance holding company) including Meritz 4 FCs without a holding company including Anbang Insurance, Yuanta, BNP Paribas, and KClavis

The table distinguishes between “mixed activity group” (MXG), banking group” (BG) and “financial conglomerate” (FC). A corporate group containing one or more commercial or industrial entities, besides financial institutions is called a “mixed activity group” (MXG) in this questionnaire; otherwise, it is called a “financial conglomerate” (FC). If a financial group (of regulated and unregulated financial institutions) is headed by a bank, or where banking institutions are preponderant, it is called “banking group” (BG).

Appendix IX. Selected Prudential Limits for Deposit Taking Institutions

	Banks	Mutual Savings Banks	Mutual Credit Cooperatives
Minimum capital ratio	BASEL 3 BIS capital ratio: 8 percent Tier 1 capital ratio: 6 percent CET 1 capital ratio: 4.5 percent Capital conservation buffer: 2.5 percent SIFI surcharge: 0-2 percent CCyB: 0-2.5 percent	BASEL 1 BIS capital ratio: 7 percent (8 percent for MSBs with assets above KRW 1 trillion)	Net capital ratio *
			<i>Credit Unions, Fisheries and Forestry Cooperatives: 2 percent</i>
			<i>Agricultural Cooperatives: 5 percent</i>
			<i>Community Credit Cooperatives: 4 percent</i>
Exposure limit	Single borrower: Less than 20 percent of bank capital for the same individual borrower and company	Less than 20 percent of capital (KRW10 billion for a company, KRW5 billion for an individual business owner, and KRW800 million for an individual)	Larger of either 20 percent of capital or 1 percent of total assets (for individual borrower)
	Same borrower (borrower and related parties as a whole): Less than 25 percent of bank capital	Same as banks	
	Limit on large exposures: Less than 500 percent of bank capital	Same as banks	
Maximum loan-to-deposit ratio	100 percent (N/A for policy banks)	110 percent until 2020 100 percent until 2021	80-100 percent **
Minimum liquidity ratio (domestic currency)	LCR: 100 percent NSFR: 100 percent (N/A for KEXIM)	Liquidity ratio: 100 percent ***	N/A
Others	FX position to capital - Composite: max 50 percent - FX FW: max 40 percent FX LCR: 80 percent (60 percent for KDB; N/A for KEXIM, banks with FX liabilities under USD 500 million and less than 5 percent of the total liabilities) FX (1M) liquidity ratio for above exempted b. 85 percent, mismatch above -10 percent Stable foreign exchange funding ratio: 100 percent (90 percent for KEXIM)	Loan loss provision coverage ratio: 100 percent Provisioning ratio for retirement benefits: > 100 percent	Loan loss provision coverage ratio: 100 percent Provisioning ratio for retirement benefits: > 100 percent
*) NCR= **) LTD= ***) Liquidity ratio =			

Classification and Provisioning Rules for Deposit Taking Institutions

Classification criteria (months overdue)					
	Banks	MCCs (2013) ⁱ	MCCs (2018)	MSBs ⁱⁱ (2013)	MSBs (2018)
Normal	<1	<3	<1	<2	<1
Precautionary	<3	<6	<3	<4	<3
Substandard	>3	>6	>3	>4	>3
Doubtful	>3 and <12		>3 and <12		>3 and <12
Presumed loss	>12	>6 (certain loss)	>12		>12

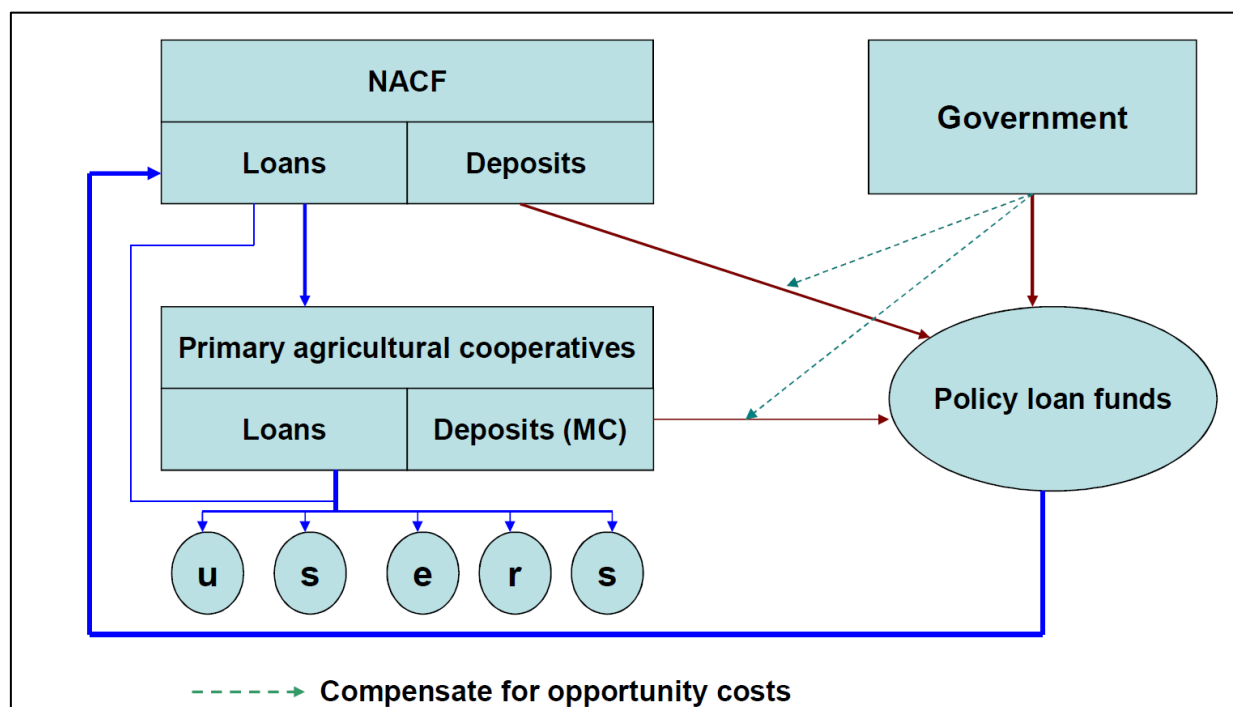
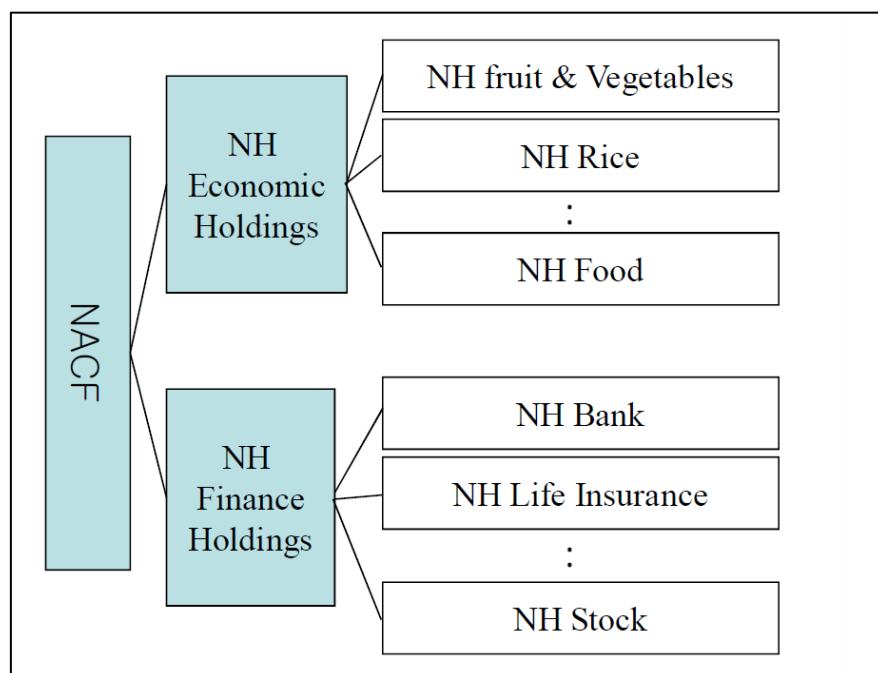
Provisioning rates for household loans (in percent)					
	Banks	MCCs ⁱ	MSBs ⁱⁱ (2018)	MSBs (2019)	MSBs (2020)
Normal	1	1	0.7	0.9	1
Precautionary	10	10	5	8	10
Substandard	20	20	20	20	20
Doubtful	55	55	55	55	55
Presumed loss	100	100	100	100	100

Provisioning rates for corporate loans (in percent)					
	Banks	MCCs ⁱ	MSBs ⁱⁱ (2018)	MSBs (2019)	MSBs (2020)
Normal	0.85	1	0.6	0.7	0.85
Precautionary	7	10	4	5	7
Substandard	20	20	20	20	20
Doubtful	50	55	50	50	50
Presumed loss	100	100	100	100	100
i) Mutual credit cooperatives					
ii) Mutual savings banks					

Appendix X. Prudential Framework for Internet Banks

Grace Period for Internet Banks (On the assumption of banks starting operation in 2017)					
	2017	2018	2019	2020 to 2022	After 2023
Capital regulations	Grace period (Basel I applied)			Phase-in of Basel III	Full implementation of Basel III
LCR	Above 80 percent	Above 90 percent	Full implementation (Above 100 percent)		
NSFR/ Leverage ratios	Grace period			Full implementation (Above 100 percent for NSFR, and above 3 percent for leverage ratios)	

Appendix XI. Organization of National Agricultural Cooperatives Federation (NACF)



Source: Park, Seong-Jae, Korea Rural Economic Institute