

**Republic of Korea: Financial System Stability Assessment,  
including Reports on the Observance of Standards and Codes on  
the following topics: Monetary and Financial Policy Transparency,  
Banking Supervision, Securities Regulation, Insurance Regulation,  
Corporate Governance, and Payment Systems**

This Financial System Stability Assessment on the **Republic of Korea** was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **February 14, 2003**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the **Republic of Korea** or the Executive Board of the IMF.

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REPUBLIC OF KOREA

**Financial System Stability Assessment**

Prepared by the Monetary and Exchange Affairs and Asia and Pacific Departments

Approved by Stefan Ingves and Wanda Tseng

February 14, 2003

In 2001/2002 Korea participated in the Financial Sector Assessment Program (FSAP). Three missions examined Korea's observance of international codes and standards and assessed the overall vulnerability of the country's financial sector to short-term risks and medium term challenges. A follow-up TA mission examined in more detail issues related to derivative markets.

The main findings of the report are as follows:

- Korea has made notable progress in improving supervision of the financial sector and in reforming the legal, institutional, and regulatory framework. It has achieved a high degree of observance of key standards and codes through newly revised laws and competent supervision, but supervisory independence could be strengthened to improve the ability to provide authoritative guidance and interpretation, and legal protection of supervisors should be strengthened.
- Reform of the banking sector has restored profitability and improved its strength and resilience, but weaknesses in risk management capabilities remain. The rapid shift to new areas of business and the fast growth of off-balance sheet exposures require close supervisory monitoring.
- Progress in the nonbank financial sector has been less pronounced. The insurance sector remains weak and undercapitalized, as do many non-bank deposit taking institutions and securities firms. The authorities are in the process of addressing the problems in the credit-union sector, taking steps towards resolving unviable institutions. Other supervisory measures to strengthen oversight for different non-bank financial institutions are warranted.
- Remaining challenges are to complete the reform agenda by adopting a new insolvency framework, to fully adapt the supervisory and regulatory regime in accordance with international codes and standards, to reform auditing and accounting practices and improve corporate disclosure, and to complete the necessary corporate restructuring.

The missions met with Mr. Yun-Churl Jeon, Deputy Prime Minister and Minister of Finance and Economy; Mr. Seung Park, Governor of the Bank of Korea; Mr. Keun-Young Lee, Chairman of the FSC/FSS; and senior officials of these institutions, and other government agencies. The mission also held extensive discussions with local and foreign market participants, economic research institutes, and with members of the academic community.

Mission members participating in all missions comprised Tomás J.T. Baliño (IMF, MAE—mission chief), Larry Promisel (World Bank, FSEGP—deputy mission chief); Anne-Marie Gulde (IMF, MAE—IMF team leader), Meral Karasulu, and Matthew Jones (all IMF, MAE); members participating in selected missions were Kenneth Kang, Henry Ma and Dong He (IMF, APD); Greta Mitchell Casselle and Jahanara Zaman (IMF, MAE), Thomas Laryea and Stuart Yikona (IMF, LEG); Magally Bernal and Sonia Echeverri (IMF, MAE, Administrative Assistants), Oliver Fratzscher, Peter Kyle, William Mako, Behdad Nowroozi, Craig Thorburn (all World Bank), Jonathan Katz (U.S. Securities and Exchange Commission), Alan Ball (U.K. Financial Services Authority), Chu-Yun Pae (U.S. Federal Reserve Bank of San Francisco), Gregory Johnston (payment system expert, Reserve Bank of Australia); Pedro Teixeira (prudential supervision expert, European Central Bank); Bengt Radstam, (debt management expert, Swedish National Debt Office); and Fot Chyi Wong, (foreign exchange expert, Monetary Authority of Singapore).

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## SECTION I—STAFF REPORT ON FINANCIAL SYSTEM STABILITY

### I. SUMMARY AND OVERALL STABILITY ASSESSMENT

- 1. Korea's macroeconomic performance since the 1997–98 crisis has been impressive.** Real GDP growth has averaged 7¼ percent annually during 1999–2002, and inflation has remained low. A downturn in 2001, which resulted from external shocks, appears to have been overcome following the recent expansion of both domestic and external demand, and real GDP is now estimated to have grown by 6 percent in 2002. Core inflation has remained within the 2–4 percent target range, partly due to the 10 percent nominal appreciation of the won against the dollar since late 2001. Foreign exchange reserves are expected to reach almost twice short-term debt this year. Reflecting these positive developments, major rating agencies recently upgraded Korea's credit ratings (to A- by S&P). Because of these upgrades, Korea is no longer included in the EMBI+ index.
- 2. Since the crisis, Korea has made major progress in financial and corporate sector reform:** the supervisory and regulatory regime for the financial sector has been substantially strengthened, and recent reforms have helped achieve a high degree of observance of international standards and codes. The problem of non-performing assets and widespread insolvency of financial institutions has been largely addressed—especially for the banking sector. This sector has undergone significant consolidation: banks have become more profit oriented, cutting costs, streamlining their operations, shedding staff, and consolidating branches. As a result, in 2001 the sector registered a profit for the first time since the crisis. Foreign participation in the banking sector has tripled since 1996.
- 3. The recovery of the financial sector has taken place in an overall favorable macroeconomic environment, which greatly facilitated the improvement of measured financial sector soundness.** However, while much has been achieved since the crisis, there are still some substantial gaps to be filled. In particular, there remain some important reform measures in the insurance and securities sectors, the adaptation of the insolvency framework, and the completion of corporate restructuring. The challenge is now to complete the unfinished reform agenda, to fully implement the revised supervisory and regulatory regime, and to address the reform needs related to domestic and global developments.
- 4. Despite notable progress in prudential supervision, concerns remain about the supervisor's ability to fully supervise the management of certain risks and respond to new challenges.** Examples of such risks include the rapidly growing off-balance sheet positions of banks, the capital position of insurance companies, and the derivative activities of securities firms. Also, despite the important role of connected lending and cross ownership in the financial crisis, disclosure and monitoring of these issues remains weak. Additional concerns include the implementation of asset classification and low provisioning rates, given remaining weaknesses in the corporate sector. Off-site supervisory practices should be enhanced: The supervisory agency does not yet analyze the results of stress-tests of individual institutions in a systematic manner, which would allow a better assessment of individual and systemic risk. Finally, making the division of responsibilities between MOFE, FSC, and the FSS more transparent, and reassuring markets about the independence of the regulator would be important.

5. **Recapitalization of commercial and specialized and development banks is largely complete.** Stress tests on the banking sector's loan portfolio suggest that it can handle isolated shocks without compromising its soundness, although a combination of shocks could be problematic for at least some institutions. The rapid growth in off-balance sheet positions requires improvements in banks' risk management capabilities and adaptations to supervisory oversight. Banks are also increasingly exposed to potential adverse developments in household income, as lending to the household sector has been increasing rapidly. Recent measures to strengthen provisioning for household lending are welcome.
6. **The forthcoming Basel II Capital Accord, the introduction of bancassurance, and the growth of derivatives and other off-balance sheet activities** will pose even greater demands on both financial institutions and supervisors, including requiring more sophisticated systems to assess and price inter-related risks. The FSC/FSS will need to evaluate the adequacy of its resources, especially staff, to deal with these issues.
7. **The insurance sector remains financially weak with most life insurance companies undercapitalized.** The capital adequacy requirement also needs to be redefined. Stress tests show the vulnerability of the sector to shocks to interest rates and equity prices. Greater transparency of the 'quasi-insurance' sector would enhance competition. Pension reform is another important pending topic, since under current policies Korea's partially funded public pension system will not be able to deliver the promised benefits to the rapidly aging population.
8. **Nonbank deposit taking institutions face soundness problems and some parts seem inadequately supervised.** This is particularly worrisome given the sector's size and the reputational consequences should there be runs on these institutions. The FSC/FSS should continue to strengthen the oversight of these institutions and resolve promptly any that are insolvent. Securities markets are highly volatile. Tighter supervision of the securities houses—particularly to curb excessive risk-taking by weakly capitalized institutions—seems warranted. Three investment trust companies are financially weak.
9. **Money, bond, and foreign exchange markets are still less developed than could be expected in a market of Korea's size and income level.** The observed lack of depth is, in part, related to segmentation in the government debt market and a lack of key maturities. Consolidation of government and government-guaranteed debt will help to enhance transparency and reduce market segmentation. Further necessary steps include the introduction of short-term securities—to provide a benchmark to the market and to allow the use of MSBs solely for liquidity management—and the removal of some remaining impediments to foreign participation. Measures to increase institutional investor participation and more regular and larger issues of long-term bonds would also foster market development.
10. **Corporate governance and disclosure have improved but further steps are needed.** Accounting and auditing reform should continue, to align Korea with evolving international best practice. Audit committees need to become more effective. Other reform areas include improved corporate disclosure, particularly with regard to related party transactions, strengthening of shareholder rights, and a clearer role for and professional training of outside directors.

11. **Corporate restructuring has made significant progress, but up to a quarter of Korean corporations remain unprofitable and highly leveraged.** Exposure of banks to such companies remains a concern. While current proposals to modernize the insolvency regime go in the right direction, the delay in completing this work is unfortunate as it remains a key step to give Korea an appropriate framework to deal with corporate distress. Passage of the new draft insolvency law that has recently been issued is therefore of key importance.

12. **Korea has made considerable strides towards observance of the Financial Action Task Force's (FATF) recommendations on combating money laundering and the financing of terrorism, but some measures detailed in this report remain to be taken to achieve full observance of the applicable international guidelines.**

## II. MACROECONOMIC AND FINANCIAL SECTOR CONTEXT

### A. Current Macroeconomic Environment

13. **Korea's macroeconomic performance since the 1997-98 crisis has been impressive but the near-term outlook depends on continued global recovery.** Real GDP growth has averaged 7¼ percent annually during 1999-2002, and inflation has remained low. Vulnerability to a balance of payments crisis has been sharply reduced, with Korea operating a floating exchange rate and with foreign reserves reaching almost two times short-term debt. Reflecting such positive developments, Korea has been the first country to graduate from the EMBI+ index following credit rating upgrades by all the major rating agencies. Korea's ratings have almost regained pre-crisis levels.

14. **Recent developments in capital markets have reflected diminished confidence in the global recovery, and risks of a further run up in oil prices.** The KOSPI and KOSDAQ have given back the significant gains recorded earlier in 2002, and bond yields have moved in a similar fashion. The real estate market, however, has remained buoyant. While overall house price inflation on a 12-month basis slowed slightly from a peak of 17.7 percent in April to 17.1 percent in November, apartment price increases in Seoul remained high at 31 percent overall, and higher increases in some districts, fueling concerns about a real estate bubble. Such concerns have abated in late 2002 as house price increases have slowed notably as a result of policy measures adopted in October 2002, with small price declines in the areas with the highest previous increases.<sup>1</sup>

### B. The Financial Sector Context

15. **Korea's financial sector is large and diversified, including banks, various non-bank deposit taking institutions, securities firms and insurance companies (Table 1).** Pension schemes are still in their infancy. In international comparison, given Korea's size and level of development, the sector seems heavily focused on bank intermediation, with a comparatively smaller role of securities and equities markets.

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<sup>1</sup> The recent house price increases are also likely to reflect one-time structural changes, including the introduction of mortgages.



Table 1. Korea: Structure of the Financial System, 1997–2002.6  
(As of the end of period, trillion won and in percentage)

	No. of Institutions			Total Assets								Assets as a % of GDP			
	1997	2001	Jun-02	1997		2000		2001		Jun-02		1997	2000	2001	Jun-02
				Amount	%	Amount	%	Amount	%	Amount	%				
Banking Institutions	84	63	62	701.3	55.8	887.7	56.9	853.1	53.9	892.5	53.1	154.7	170.1	156.5	158.5
Commercial Banks	78	58	57	483.5	38.5	598.3	38.4	606.7	38.3	639.1	38.0	106.7	114.6	111.3	113.5
National Banks	16	9	9	379.0	30.2	505.9	32.4	508.3	32.1	530.8	31.6	83.6	96.9	93.3	94.2
Regional banks	10	6	6	58.7	4.7	45.5	2.9	49.0	3.1	50.9	3.0	13.0	8.7	9.0	9.0
Foreign Bank Branches 1/	52	43	42	45.8	3.6	46.9	3.0	49.4	3.1	57.4	3.4	10.1	9.0	9.1	10.2
Specialized and Development banks	6	5	5	217.8	17.3	289.4	18.6	246.4	15.6	253.4	15.1	48.1	55.4	45.2	45.0
Non-bank Depository Institutions	6,404	4,742	1,372	234.2	18.6	215.0	13.8	227.8	14.4	232.7	13.9	51.7	41.2	41.8	41.3
Merchant Banking Corporations 2/	30	3	3	77.9	6.2	21.3	1.4	13.8	0.9	13.1	0.8	17.2	4.1	2.5	2.3
Mutual Savings Banks	231	122	120	36.0	2.9	24.2	1.6	24.2	1.5	25.7	1.5	8.0	4.6	4.4	4.6
Credit Unions	1,666	1,268	1,248	19.3	1.5	21.0	1.3	23.4	1.5	23.6	1.4	4.3	4.0	4.3	4.2
Mutual Credit Facilities	1,733	1,618	n.a.	61.8	4.9	87.0	5.6	95.9	6.1	98.9	5.9	13.6	16.7	17.6	17.6
Community Credit Cooperatives	2,743	1,730	n.a.	29.8	2.4	37.1	2.4	40.1	2.5	40.4	2.4	6.6	7.1	7.4	7.2
Postal Savings	1	1	1	9.3	0.7	24.5	1.6	30.3	1.9	31.0	1.8	2.0	4.7	5.6	5.5
Insurance Companies	46	34	35	118.1	9.4	163.6	10.5	188.9	11.9	200.0	11.9	26.0	31.3	34.7	35.5
Life Insurance Companies	31	19	19	92.5	7.4	122.8	7.9	139.1	8.8	149.8	8.9	20.4	23.5	25.5	26.6
Non-life Insurance Companies	14	14	15	19.9	1.6	28.0	1.8	32.7	2.1	33.0	2.0	4.4	5.4	6.0	5.9
Postal Insurance	1	1	1	5.6	0.4	14.8	0.9	17.1	1.1	17.2	1.0	1.2	2.8	3.1	3.1
Securities Companies 3/	36	46	44	27.4	2.2	43.8	2.8	42.0	2.7	51.7	3.1	6.0	8.4	7.7	9.2
Collective Investment Schemes	81	242	264	174.9	13.9	249.7	16.0	270.6	17.1	303.2	18.0	38.6	47.8	49.7	53.8
Investment Trust Management Companies 4/	49	31	31	94.6	7.5	142.1	9.1	154.2	9.7	165.1	9.8	20.9	27.2	28.3	29.3
Securities Investment Companies	-	192	214	n.a.	n.a.	4.1	0.3	6.1	0.4	8.9	0.5	n.a.	0.8	1.1	1.6
Trust Accounts of Banks 5/	32	19	19	80.3	6.4	98.9	6.3	110.3	7.0	129.2	7.7	17.7	18.9	20.2	22.9
<b>Total</b>	<b>6,651</b>	<b>5,127</b>	<b>n.a.</b>	<b>1,255.8</b>	<b>100.0</b>	<b>1,559.7</b>	<b>100.0</b>	<b>1,582.5</b>	<b>100.0</b>	<b>1,680.1</b>	<b>100.0</b>	<b>277.0</b>	<b>298.8</b>	<b>290.4</b>	<b>298.3</b>

Sources : The Bank of Korea, Monthly Statistical Bulletin, and Financial System in Korea, February 15, 2002, and The Financial Supervisory Service, Monthly Financial Statistics Bulletin.

1/ Number of foreign bank branches (in the banking institutions) is as of September 1997.

2/ Including investment and finance companies.

3/ Domestic companies only.

4/ The figures in 1995 are for investment trust companies.

5/ Assets in trust accounts of banks is defined as total trust assets minus securities investment trust of investment trust management companies.

## The banking sector

16. **As of mid-2002, the banking sector included nine nationwide commercial banks, six regional banks, five specialized and development banks, and 42 foreign bank branches.** Commercial banks primarily engage in traditional financing of the corporate and the household sectors, but they also have limited activities in securities business and factoring, and in derivatives—an area of recent rapid growth. Most banks have leasing and credit card operations. It is expected that bancassurance will become permissible in 2003. Commercial banks are banned from owning real estate other than for business purposes. Specialized and development banks include the Industrial Bank of Korea (IBK), the Korean Development Bank, (KDB), and the Korea Export Import Bank (KEXIM), and the banking arms of two federations of cooperatives. These banks were founded initially to provide funds to strategic sectors but they now also undertake significant commercial banking activities.

17. **Key characteristics of the Korean banking sector are a high share of government ownership and increasing concentration.** As part of the restructuring efforts following the crisis, government and foreign ownership increased significantly. Prior to the crisis the government held equity in only three banks, amounting to less than 18 percent of total assets. After the restructuring, eight out of 15 commercial banks are now either majority government owned or co-owned by the government and private owners. When combined with government-ownership in specialized and development banks, in mid-2002 nearly 60 percent of the assets of the Korean banking sector is government-controlled. Foreign ownership increased from about 10 percent in 1998 to more than 30 percent in 2002.<sup>2</sup> Concentration before the crisis was moderate, but increased considerably with consolidation in the sector.<sup>3</sup> The share of the three and five largest banks stood at 51 and 69 percent of total sector assets, respectively. Following the merger of Hana Bank and Seoul Bank in 2002, three large banks now dominate the market.<sup>4</sup> The structure of the banking sector continues to evolve in response to the government's ongoing privatization efforts.

18. **The restructured banking sector has demonstrated improved asset quality, higher earnings, and in 2001 showed profits for the first time since the crisis.** Aggregate capital adequacy levels are close to 11 percent, although shareholders' equity capital remains relatively low compared to total (non-risk weighted) capital. Liquidity of commercial banks is adequate. Assets reached nearly W 900 trillion at the end of 2002, amounting to about 160 percent of GDP (Tables 2 and 3).

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<sup>2</sup> Since 1998, banks being restructured were exempted from foreign ownership restrictions in an effort to introduce fresh capital and managerial know-how into the sector.

<sup>3</sup> The Herfindahl-Hirshman index doubled from 0.07 in 1996 to 0.14 in 2001, due to the impact of the restructuring process on the number and the size distribution of banks.

<sup>4</sup> Kookmin, Woori FHC, and Hana and Seoul have a combined share of about 54 percent of the commercial banking sector assets at end-2001.

Table 2. Korea: Selected Financial Soundness Indicators for Commercial Banks, 1997-2002(June)  
(In trillions of won and in percentage)

	1997	1998	1999	2000	2001	Mar-02	Jun-02
<b>Capital adequacy</b>							
Regulatory capital to risk-weighted assets (BIS ratio)							
All commercial banks	7.0	8.2	10.8	10.8	10.8	10.8	10.6
Nationwide commercial banks	6.7	8.2	10.8	10.5	10.8	10.8	10.5
Regional commercial banks	9.6	8.3	11.4	10.8	10.8	10.5	11.6
Shareholders' Equity as a % of total assets	4.3	3.8	4.8	4.3	4.7	5.0	5.0
<b>Asset quality</b>							
Non-performing loans as a % of total loans 1/	6.0	7.4	8.3	6.6	2.9	2.5	1.9
Substandard or below loans (SBLs) as a % of total loans	--	--	13.6	8.9	3.3	2.9	2.5
SBLs net of provisions as a % of total loans	--	--	8.1	4.5	1.9	1.6	1.4
Provisions for SBLs (tri. won)	--	--	--	16.7	5.7	5.4	4.7
Provisions for SBLs as a % of SBLs	--	--	--	52.1	45.3	46.5	45.3
Provisions for total loans (tri. won)	--	--	--	19.5	9.4	10.1	8.9
Provisions for total loans as a % of SBLs	--	--	--	61.0	74.0	87.0	85.5
Provisions for total loans as a % of SBLs (including S&D banks)	--	--	--	59.4	76.1	86.2	91.9
Provisions for total loans as a % of NPLs	--	--	--	81.8	85.2	101.4	109.4
<b>Large credit exposure 2/</b>							
Large exposure as a percentage of equity capital	--	--	--	--	51.3	31.2	25.8
Large exposure as a percentage of total credit exposure	--	--	--	--	6.4	3.7	2.9
<b>Credit concentration</b>							
Total loans (in tri. won)	147.9	146.1	184.3	231.9	270.7	296.7	321.8
<i>Of which:</i>							
Share of loans to corporations	63.8	63.6	61.2	56.2	48.7	47.7	46.8
Share of loans to households	20.0	18.3	23.4	28.0	38.4	39.6	40.2
Share of housing loans 3/	13.8	14.0	12.4	11.3	11.1	11.0	11.4
Total credit exposure to Chaebol (tri. won) 4/	--	--	--	57.5	45.7	--	43.8
Total credit exposure to Chaebol % of total loans 4/	--	--	--	24.8	16.9	--	13.6
<b>Earnings and profitability</b>							
Return on assets (pretax net income)	-0.9	-3.3	-1.3	-0.6	0.8	--	--
Return on equity (pretax net income)	-14.2	-52.5	-23.1	-11.9	15.9	--	--
Interest income as a percentage of gross income 5/	63.0	65.7	78.0	68.3	61.1	--	--
Non-interest income as a percentage of gross income	41.5	44.5	31.0	28.8	38.7	--	--
Operating expense as a percentage of gross income	16.0	13.1	14.3	12.2	12.3	--	--
Interest rate margin 6/	2.1	3.8	3.2	2.4	2.9	2.8	2.7
<b>Liquidity</b>							
Liquid assets to total assets 7/	--	19.7	18.1	15.5	11.7	11.0	9.9
Liquid assets to short term liabilities 8/	--	25.2	22.4	19.4	14.5	13.6	12.0
Total loans to deposit ratio	108.7	78.8	70.2	71.9	75.1	79.3	83.8
<b>Turnover ratio in the securities market (in percentage) 9/</b>							
KOSDAQ stock market	16.5	20.4	108.2	1993.8	818.2	135.5	362.7
KOSPI stock market	228.6	139.9	248.0	333.5	192.1	70.6	146.6
<b>Market-based indicators</b>							
Change in stock market index (KOSPI, in percent, e.o.p)	-42.2	49.5	82.8	-50.9	37.5	29.1	-17.1
Change in housing price index (in percent, e.o.p)	2.0	-12.4	3.4	0.4	9.9	17.3	17.1

Sources: FSS/FSC, Bank of Korea, and staff calculations.

1/ Non-performing loans are defined as loans overdue for more than three months plus non-accrual loans.

2/ Large credit exposure is defined as credit exposure larger than ten percent of bank's capital.

3/ The loans for housing is the sum of housing loans (to corporations, households, public and others) and loans with National Housing Fund.

4/ Total Credit Exposure to top 30 Large Business Groups.

5/ Gross income is defined as the sum of interest income, non-interest income, and non-operating income.

6/ Spread between reference loan and deposit rates.

7/ Total liquid assets is defined as the sum of cash and check, foreign currency, due from banks, traded securities, call loans and bills bought.

8/ Short term liabilities is defined as the sum of deposits, CDs, due to banks, due to BoK, and borrowings.

9/ Turnover ratio is defined as trading volume divided by market capitalization.

Table 3. Korea: Consolidated Summary Balance Sheet of the Banking Sector, 1999-2002.6 1/

(In trillion won and in percentage)

	1999		2000		2001		Jun-02	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
<b>Total Assets</b>	<b>661.3</b>	<b>100.0</b>	<b>748.2</b>	<b>100.0</b>	<b>809.8</b>	<b>100.0</b>	<b>840.6</b>	<b>100.0</b>
Total Earning Assets	592.6	89.6	669.2	89.4	724.2	89.4	765.5	91.1
Loans (Net)	359.9	54.4	425.5	56.9	465.4	57.5	515.6	61.3
of which: Loans in won	271.9	41.1	333.8	44.6	373.8	46.2	433.0	51.5
Loans to corporations	181.5	27.4	209.6	28.0	207.7	25.7	230.7	27.4
Loans to households	54.9	8.3	79.7	10.7	124.5	15.4	153.9	18.3
Other loans	35.5	5.4	44.5	5.9	41.7	5.1	48.5	5.8
of which: Off-shore loans	10.8	1.6	9.2	1.2	7.2	0.9	5.9	0.7
of which: Foreign currency loans	57.0	8.6	49.7	6.6	38.9	4.8	37.1	4.4
of which: Call loans	3.2	0.5	8.5	1.1	9.2	1.1	5.0	0.6
in Foreign currency	1.4	0.2	5.8	0.8	3.9	0.5	1.9	0.2
Loan Loss Reserves (-)	21.6	3.3	21.1	2.8	13.2	1.6	12.3	1.5
Other Earning Assets	232.7	35.2	243.7	32.6	258.8	32.0	249.9	29.7
Investment and Trading Securities	191.0	28.9	207.0	27.7	235.9	29.1	225.7	26.8
Deposits with Banks	41.7	6.3	36.7	4.9	23.0	2.8	24.2	2.9
of which: in Foreign currency	16.6	2.5	13.1	1.8	5.4	0.7	4.2	0.5
Non-Earning Assets	54.6	8.3	65.0	8.7	71.2	8.8	61.0	7.3
Cash and Due from Banks	18.8	2.8	17.1	2.3	17.1	2.1	11.4	1.4
of which: in Foreign currency	0.6	0.1	0.7	0.1	0.7	0.1	0.8	0.1
Other	35.9	5.4	48.0	6.4	54.1	6.7	49.6	5.9
Fixed Assets	14.1	2.1	13.9	1.9	14.4	1.8	14.2	1.7
<b>Total Liabilities &amp; Equity</b>	<b>661.3</b>	<b>100.0</b>	<b>748.2</b>	<b>100.0</b>	<b>809.8</b>	<b>100.0</b>	<b>840.6</b>	<b>100.0</b>
Customer and Short Term Funding	486.7	73.6	566.4	75.7	626.9	77.4	657.5	78.2
Deposits	339.9	51.4	425.2	56.8	478.6	59.1	501.7	59.7
of which: in Foreign currency	15.0	2.3	18.2	2.4	20.6	2.5	18.3	2.2
Other Short-term borrowing	146.8	22.2	141.2	18.9	148.2	18.3	155.8	18.5
of which: in Foreign currency	44.3	6.7	40.1	5.4	36.2	4.5	36.2	4.3
Off shore liabilities	10.7	1.6	9.7	1.3	7.8	1.0	6.5	0.8
Call money	7.2	1.1	4.6	0.6	6.5	0.8	5.1	0.6
of which: in Foreign currency	1.4	0.2	1.4	0.2	0.9	0.1	1.5	0.2
Other Funding	94.1	14.2	85.7	11.5	84.3	10.4	85.7	10.2
Bonds and Notes	65.9	10.0	68.8	9.2	70.7	8.7	78.4	9.3
Trust A/c Funds	9.4	1.4	7.1	0.9	11.7	1.4	6.2	0.7
Borrowing from the BOK in foreign currency	18.8	2.8	9.8	1.3	2.0	0.2	1.1	0.1
Other (Non-Interest bearing)	42.1	6.4	60.7	8.1	57.3	7.1	52.4	6.2
Other Reserves	5.7	0.9	5.4	0.7	2.1	0.3	2.2	0.3
Allowances for acceptances and guarantees	1.8	0.3	1.6	0.2	0.8	0.1	0.4	0.0
Equity	32.8	5.0	30.0	4.0	39.1	4.8	42.8	5.1
<b>Major Off Balance Sheet Items</b>	<b>Amount</b>	<b>Percent of capital 4/</b>	<b>Amount</b>	<b>Percent of capital 4/</b>	<b>Amount</b>	<b>Percent of capital 4/</b>	<b>Amount</b>	<b>Percent of capital 4/</b>
Acceptances and guarantees outstanding 2/	45.7	116.8	47.3	105.7	41.9	65.5	40.4	59.0
Acceptances and guarantees 2/	21.9	56.0	26.0	58.3	24.7	38.6	27.0	39.5
Derivative contracts	128.8	329.1	126.2	282.4	165.6	258.9	240.1	351.1
Contracts on interest rates	55.7	142.4	50.5	113.0	74.4	116.4	123.6	180.7
Contracts on currency 3/	73.1	186.7	75.7	169.3	91.1	142.5	115.8	169.4
Receivable charge-offs	10.2	26.0	17.5	39.2	22.3	34.9	21.6	31.6
Loans sold under repurchase agreements	6.3	16.0	5.5	12.3	5.6	8.7	4.7	6.9
Total	212.9	544.0	222.5	497.9	260.1	406.7	333.8	488.1

Source: FSS, Monthly Financial Statistics Bulletin and IMF staff calculations.

1/ Includes commercial banks and specialized banks and covers only the banking accounts.

2/ Acceptances and guarantees outstanding were moved from on-balance sheet items to off-balance sheet items from 1999.

3/ Unpaid spot exchanges were removed from off-balance items from March 2000.

4/ Capital is defined as sum of Tier I and Tier II capital.

### **Nonbank deposit taking financial institutions**

19. **Nonbank deposit taking institutions hold more than one quarter of the assets of the total deposit taking system, or about 15 percent of total financial sector assets.** The sector is diverse, including merchant banking corporations, mutual savings banks, a postal savings bank, credit unions, mutual credit facilities and community credit cooperatives. Each type of institution is specialized, and all have important limitations on their business activities.

20. **Strength varies across types of institutions, but there remain concerns about weaknesses in the sector.** Most notable are credit unions, which sustained aggregate net losses of W 6.6 billion in 2001: 15.2 percent were insolvent as of end-June 2002. Provisioning is low, and 22 percent of these institutions have been closed since 1999. The federation of credit unions (which assists in their oversight) has also reported significant losses in reserves due to low-yielding assets. Other institutions, most notably mutual savings banks, posted a decline in NPLs, even though weaknesses in different areas remain. The FSC/FSS recently suspended operations of 122 credit unions, of which 100 have been closed. In addition, improvements in supervision over the sector have been implemented.

### **Securities and fund management industry**

21. **Three modern exchanges operate in Korea, trading equities and a wide range of securities and derivative instruments.** Foreign and individual retail investors participate heavily in these markets, which exhibit comparatively high volatilities in returns. There is a lack of actively trading institutional investors, as private pension plans are still rare. Among instruments traded, derivatives have grown the fastest.

22. **Korea's securities and collective investment sector represents about 63 percent of GDP.** Collective investment schemes include more than 260 institutions but are dominated by the ITC sector, which includes 31 funds managers managing W 165 trillion assets (29 percent of GDP) and 19 trust accounts of banks which manage about W 130 trillion (about 23 percent of GDP). Sixty securities firms manage assets of about W 50 trillion (about 9 percent of GDP).<sup>5</sup> Some corporate-style investment funds were introduced in 1998, but have not been very successful. Foreign participation in ten investment trust companies, mostly through minority shares, has gradually increased to 19 percent of assets. Given concerns about the soundness of the fund management industry, investors prefer to establish their own funds and roll over investments annually.<sup>6</sup>

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<sup>5</sup> This compares, for example, to 85 percent in Australia and more than 160 percent in Singapore.

<sup>6</sup> This explains the presence of 5,700 funds and the allocation of 46 percent of assets into money market funds.

## **Insurance sector**

23. **Korea's insurance market is large in world and regional terms, ranking seventh by premium behind the United States, Japan, the United Kingdom, Germany, France, and Italy.** Gross premiums as a percentage of GDP, commonly referred to as "insurance penetration," stood at 13.1 percent, the third highest in the world after South Africa and the United Kingdom. Life insurance makes up the largest segment of the market, with 22 companies in operation. The sector was particularly affected by the crisis and the subsequent economic conditions, which exposed past product weaknesses, poor quality assets, and management focused largely on growth.<sup>7</sup>

24. **Notwithstanding improvements in regulation and supervision, insurance companies currently face important financial challenges.** Most companies have issued contracts with guaranteed rates of return above current market levels, and therefore depend on capital appreciation and other underwriting profits to overcome the losses arising from outstanding contracts still in force. Companies also carry a very substantial mismatch risk between assets and liabilities as a result of this business line. Existing business continues to be written with relatively strong guarantees, although at lower rates than in the past.

25. **The non-life insurance sector has been stable over the last 15 years.** The combined ratios for the 19 companies in the sector indicate marginal but improving profitability. Non-life insurance companies have faced less serious asset liability mismatch issues than the life insurance companies.

## **Pension sector**

26. **The emergence of the pension sector is a recent development in Korea.** It is widely expected to require reforms to properly serve the population in a demographically ageing environment. Occupational pension schemes are expected to emerge through reform of the current retirement allowance system, although the precise form of the new arrangements is undecided. The current National Pension Scheme which holds assets amounting to 15 percent of GDP is facing its own challenges as it attempts to achieve actuarial balance. These pressures arise from benefits accruing at a rate and value in excess of current contributions and an imperative to recover much of the intergenerational subsidy built into the scheme owing to lower past contributions. A small but growing tax-favored voluntary pension sector has emerged over the last five years.

## **C. Market Infrastructure**

### **Money and bond markets**

27. **Money and bond markets remain partially fragmented and, at least in certain maturities and instruments, insufficiently deep.** Unlike comparable markets, there is no core "interbank" market, which would be more efficient in terms of liquidity redistribution.

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<sup>7</sup> The number of companies in the market had increased rapidly until the crisis, jumping to 33 from eight in just ten years.

Instead, the call money market encompasses more than 600 financial and non-financial institutions that can also participate in the repo market. While the market is liquid for maturities below 90 days, liquidity dries up quickly beyond that maturity given the difficulties of pricing such deals in the absence of a suitable yield curve. The BOK conducts repo operations, using its monetary stabilization bonds (MSBs) of different maturities.

28. **The bond market encompasses corporate and government bonds of different maturities.** The government bond sector includes a range of different instruments, including bonds issued in the restructuring process (KAMCO and KDIC bonds), Exchange Stabilization Bonds, National Housing Bonds and MSBs. There have also been small issuances of 10-year treasury bonds. The multiplicity of instruments, the absence of a short term benchmark government bond (issued at regular intervals) and the insufficient volume of ten-year government bonds all constrain the market's ability to price risk, and hinder the further development of money and bond markets. The market for corporate bonds is deep but not particularly active, especially relative to its potential.

#### **Foreign exchange market**

29. **The trading volume in Korea's foreign exchange market has grown significantly since the crisis, when shallowness was a concern.**<sup>8</sup> Trading grew due to the two-stage foreign exchange liberalization program that started in April 1999, and the accompanying increase in inflows of foreign direct investment (FDI) and portfolio investments. Exchange markets also grew as a result of increases in exports and imports. There has been a notable jump in foreign exchange forward and swap transaction volumes since 1999 following the removal of the *bona-fide* (real demand) principle in the use of foreign exchange forward and derivative transactions, and the authorization for onshore financial institutions to transact in offshore non-deliverable forward contracts (NDF).<sup>9</sup> Some of the increase in foreign exchange derivative activities reflects increasing hedging activities.

30. **Notwithstanding the sharper increase in foreign exchange forward and swap transactions, spot trading still dominates, because of various restrictions and documentation requirements.**<sup>10</sup> In addition, Korea's foreign exchange market is more end-user-and domestically-oriented, with cross-border transactions accounting for about a quarter of total foreign exchange volume in 2001, compared with about 70 percent in the comparator

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<sup>8</sup> Turnover compares favorably with that in many Asian emerging market economies although it still lags behind that of most industrialized countries, Hong Kong SAR, and Singapore.

<sup>9</sup> Korean data on foreign exchange forward volume includes NDF.

<sup>10</sup> Close to two-thirds of total trade volumes are spot, compared with less than one-third in most industrialized countries, Hong Kong SAR, and Singapore. Possible reasons for this include restrictions on won-funding of nonresidents activities, documentation requirements for foreign exchange transactions involving delivery of won, and monitoring and reporting requirements, which constrain the growth of onshore forward and spot markets.

countries. The authorities plan to further liberalize the capital account in three phases over the period 2002–11 and to implement measures to broaden and deepen the foreign exchange market.

#### **D. Regulation, Supervision, and Compliance with Standards and Codes**

31. **To improve financial supervision and regulation, the authorities reorganized the sector's regulatory agencies in 1998.** The FSC was created to oversee regulation of Korean financial institutions and markets. It is a statutorily independent government agency under the general authority of the President who appoints its nine-member Board.

32. **The FSC is responsible for policy formulation for the financial markets and is the supervisory and regulatory authority for all banks and non-bank financial institutions.** The agency's powers include the authority to issue and revoke licenses for financial institutions. It is responsible for coordinating the activities of and setting policy for the Financial Supervisory Service (FSS) and the Securities and Futures Commission (SFC). The FSS is the executive arm of the FSC. MOFE is required to consult with FSC on all proposed legislation pertaining to financial markets that it submits to Parliament. MOFE, the BOK, and the Korea Deposit Insurance Corporation (KDIC) continue to have some involvement in the policymaking, examination, and supervisory process for the financial sector. As a result of the crisis, FSC was also given some responsibilities for corporate sector restructuring.

33. **Korea broadly observes international standards and codes across all segments of the financial industry but full implementation is still in progress.** The legal framework for financial institutions and supervision is well established in a number of laws.<sup>11</sup> The main findings of the standards assessments are summarized in Box 1.

### **III. SHORT-TERM VULNERABILITIES**

34. **This chapter discusses the extent to which the balance sheet exposures of the Korean financial sector alone or in conjunction with other structural weakness could imply short-term vulnerabilities.** Korea's banking sector seems broadly resilient to isolated macroeconomic shocks of a plausible size based on the experience over the last five years. However, a combination of shocks could be problematic to at least some institutions. Stress tests for the insurance sector yield more worrisome results, showing that some companies could suffer unsustainable losses even from moderate changes in interest rates and stock prices. In addition to those quantifiable risks, the chapter also discusses structural risks—

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<sup>11</sup> This includes the Banking Act (BA), the Bank of Korea Act, the Act on the Establishment of Financial Supervisory Organizations (AEFSO), the Act on the Structural Improvement of the Financial Industry (ASIFI), the Depositor Protection Act, the Monopoly Regulation and Fair Trade Act, the Civil Code, the Bankruptcy Act, the Foreign Exchange Transactions Act, the Act on the Insurance Business and their associated enforcement decrees, implementing regulations and rules.



### Box 1. Main Findings of the Assessment of Observance of Key International Standards and Codes

The FSAP team conducted assessments of Korea's observance of the following key international standards and codes:

- The review of the **Basel Core Principles (BCP)**, **IAIS**, and **IOSCO** shows that the FSC/FSS, the unified supervisory agency, is a competent regulator. Assessors felt though that the supervisory framework and implementation should be reviewed to strengthen the supervisor's independence, including its ability to provide authoritative guidance and interpretation. Legal protection of supervisors should be strengthened.
- **Basel Core Principles.** There is a high degree of compliance with best international supervisory practices in banking supervision. Measures needed to further strengthen compliance with the BCP would include: (i) increasing staffing in key areas: this will also help to address the challenges of new supervisory tasks related to off-balance sheet activities, Basel II, and AML; (ii) paying greater attention to differing risk levels when setting minimum capital levels; (iii) broadening the coverage of fit and proper criteria; and (iv) giving more attention to qualitative criteria in supervision.
- **IAIS.** There is also a high degree of compliance with the IAIS. Measures initiated to strengthen the insurance sector go in the right direction but may need to go further. In particular the new capital requirements for life insurance companies, even when fully phased-in may not be adequate given Korea's structural and financial framework. In addition, a withdrawal of the government from direct insurance business, facilitating the listing of insurance companies on the stock exchange, further price and product liberalization and further deepening of the capital markets would all help to further strengthen the insurance sector.
- **IOSCO.** Korea has achieved significant observance of the IOSCO principles, but some critical issues remain. They include: (i) the need to improve regulatory transparency, (ii) in the volatile market framework, regulators should require more frequent calculation and reporting of capital requirements, and (iii) extended enforcement of prudential rules could increase market confidence.
- **CPSIPS.** BOK-Wire, Korea's RTGS payment system, is efficient and compliant with all CPSIPS principles, but the BOK's role in the payments system should be explicitly set out in the legislation, and accompanying legislative powers should also be introduced. In addition, the check system remains important, including in OTC settlement. The BOK is aware of the systemic risks implied in the use of checks for large value payments. However, there are efforts to encourage a broadening of the use of BOK-Wire for large transfers, especially for payments related to OTC trades. It appears though that there are some significant obstacles, including the (t+0) settlement practice in debt securities trade. Other important obstacles to reducing the role of checks are related to the widespread use of cashiers' checks as a substitute for cash, encouraged further by the low value of the largest denomination bill.
- **Code of Good Practices in the Transparency of Monetary and Financial Policies.** All assessed financial institutions in Korea practice a high degree of transparency. The practice could be improved through better information sharing arrangements, wider consultation on technical changes to regulations and better disclosure of internal governance procedures.
- **OECD Principles of Corporate Governance.** Corporate governance rules are close to those in other OECD countries, but actual practice remains an issue. Efforts will be needed to improve the transparency of business practices and ensure adequate disclosure for chaebols.
- **AML/CFT.** Korea has put in place the legal and institutional framework necessary for an effective framework for anti-money laundering (AML) and combating the financing of terrorism (CFT) but more focus needs to be given to implementation. To make the framework operational, more staff resources should be devoted to the Korea Financial Intelligence Unit (KoFIU). The FSS/FSC should fully exercise its mandate in this area, avoiding the need to build up a parallel structure within the KoFIU.

including the exposure of banks to off-balance sheet risks, weaknesses in the securities and ITC sectors, and recent capital losses in non-bank financial institutions. The latter risks deserve careful monitoring, as they could cause serious problems in the financial sector, even in the short-run.

#### **A. Exposures of the Banking Sector**

35. **Short-term risks may arise from the direct effect of shocks to interest and exchange rates on bank balance sheets, and from indirect effects through corporate and household balance sheets, and from off-balance sheet items.** This risk may be sizeable as bank lending remains a principal source of corporate financing, and, going forward, the quality of household credit is also likely to suffer. Given the recently rising level of household debt, increases in interest and exchange rates could significantly undermine household debt servicing capacity. Loans to households grew at an annualized rate of 34 percent in the first half of 2002, and, starting from low levels, total household debt has now reached average G-7 levels, but with a lower share of mortgages. Off-balance sheet exposures of banks have also been growing rapidly in the past two years.<sup>12</sup>

36. **In examining vulnerabilities, the guiding rod has been the size of shocks experienced since 1998, which are smaller than those experienced during the crisis.** This approach was chosen for two reasons: (i) Shocks of the magnitude experienced in 1997–98 would most likely lead to structural breaks in the relationships underlying the stress tests. The results based on models estimated in calmer times may therefore not be able to give adequate quantitative guidance for what would happen in a crisis situation. (ii) Since the crisis, Korea has put in place safeguards that would make a reoccurrence of shocks of the 1997–98 magnitude very unlikely.

#### **Bank exposure to interest and exchange rate shocks**

37. **Banks appear resilient to the direct effects of interest and exchange rate shocks on the balance sheet items considered in the tests, mainly because of the absence of large currency and maturity mismatches.** Present Basel capital ratios show little change in the face of a modest increase in interest rates (a permanent rise in interest rates by two percentage points), and virtually no change in the face of either a temporary or a permanent depreciation of the exchange rate (of 20 percent, in the temporary case reversed after one year).

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<sup>12</sup> Due to data limitations, stress tests conducted for this report measure impacts on on-balance sheet items only, discussed in detail as part of the follow-up technical assistance mission, which showed that most domestic banks have matched positions. Banks are conducting regular value-at-risk (VaR) exercises for market risks for all exposures, including derivatives. In light of potential future growth, the FSS will need to be vigilant in evaluating these exercises.

### **Exposure to the corporate sector**

38. **Exposure to interest rate risk and earnings risk are the main source of vulnerabilities for the corporate sector, despite historically low interest rates and strong growth in the economy.** Given the reduced direct foreign borrowing of corporations and the increase in hedging, the corporate sector appears less sensitive to foreign exchange rate risk than at the time of the crisis. However, many companies appear not to hedge consistently. Moreover, given the differences in the quality of hedges available in the Korean market, even those that do hedge may face risks. Stress tests suggest that a deterioration in corporate sector balance sheets from higher interest rates or lower operating income would worsen the quality of bank credits. As a result, capital ratios of banks would decline by less than one percentage point for the banking system as a whole, although for individual banks the fall could be higher. Given the still comfortable levels of capital, the banking system is therefore likely to be able to absorb each of these shocks individually. However, if a series of simultaneous shocks were to occur together, the potential impact on individual banks could bring capital ratios under pressure for some of the smaller, less well-capitalized institutions.

### **Exposure to the household sector**

39. **Stress tests were also conducted to assess the effects of changes in interest rates on the household debt burden and the implied feedback effects on nonperforming loans and on capital ratios.** From the baseline, three variations of the shocks are presented. The first allows for no reaction from interest rates. The second treats the shock as a demand shock, and allows for a 150 basis point reduction in interest rates. The third treats the shock as a supply shock, requiring a 50 basis point increase in interest rates.

40. **Stress tests for household credit indicate that the shocks used could generate very small loan defaults if they are demand shocks, but defaults as large as 8–9 percent of household credit outstanding if they are supply shocks.** The Basel capital ratio of the banking sector could decline by around 1.5 percentage points. The results of the stress test show that the banking system as a whole could be at risk of possible capital losses from their exposures to households. The risk is accentuated by the higher credit risk of new lending, and by the fact that the particular loan structure of most household loans (three-year bullet loans with only interest due in the interim) is likely to lead to an understatement of problem loans in the household sector. Against this background, added vigilance is necessary and the measures announced by the authorities in October 2002 to curb the growth in household lending are steps in the right direction. There has also been some active provisioning against such risks.

## **B. Exposure of Insurance Companies to Macroeconomic Shocks**

41. **The insurance sector suffers from weaknesses that might endanger its own financial standing and the wider confidence in the financial sector.** The life insurance sector carries considerable mismatch risk. Industry participants advised that the mean term of their liabilities is of the order of seven years and the mean term of their assets is, at best, three years. In such a situation, falls in interest rates will be unfavorable to the companies. Insurance companies are also invested in equity markets, linking their solvency

Table 4. Balance Sheet Sensitivity of Korean Banks, June 2002

(In percent of risk weighted capital)

	Average for all Banks	Largest Increase	Largest Decrease
<b>Commercial Banks</b>			
Initial Basel Capital Ratio 1/	10.6	-	-
After Interest Rate Shock 2/	9.4	0.0	- 2.1
After Exchange Rate Shock 3/	10.7	0.2	- 0.4
After Open Foreign Exchange Position Shock 4/	10.6	0.0	0.1
After Foreign Interest Rate Shock 5/	10.6	0.0	0.1
<b>Specialized Banks</b>			
Initial Basel Capital Ratio 1/	13.8	-	-
After Interest Rate Shock 2/	12.9	0.0	- 1.9
After Exchange Rate Shock 3/	13.9	0.3	0.0
After Open Foreign Exchange Position Shock 4/	13.8	0.0	- 0.1
After Foreign Interest Rate Shock 5/	13.9	0.3	0.0

Sources: Staff estimates.

1/ Basel capital ratio: Defined as Tier 1 plus Tier 2 capital to risk-weighted assets, at end-June 2002.

2/ Interest rate shock: A 2 percentage point increase in domestic interest rates.

3/ Exchange rate shock: A 20 percent increase in the won value of foreign currency denominated assets and liabilities, reversed after one year.

4/ Open foreign exchange position shock: A depreciation of the won against currencies composing the open position in the amount of the mean depreciation over 1997–2002 plus two standard deviations of the series.

5/ Foreign interest rate shock: A 2 percentage point increase in foreign interest rates.

to equity price moves. Finally, insurance companies are allowed to invest up to 20 percent of their assets abroad.

42. **Stress tests for the insurance industry suggest that the insurance sector could suffer from changes in interest rates, stock or foreign exchange values.** As a result, for the life sector in particular, the risk of a repeat of the need for government intervention in some ways remains material. In contrast, based on an analysis of its balance sheets, the non-life sector is better placed with a stronger valuation basis for liabilities, more closely matched assets and liabilities, and excess capital generally sufficient to enable it to cope with foreseeable adversity in the economic environment. A continued strengthening of the operating framework for life insurance will be critical to reduce the sector's vulnerability.

Table 5. Impact of Macroeconomic Shocks on the Corporate Sector and Implied Effects on Banking Sector 2001 Base

	Interest Rate Shock	Exchange Rate Shock	Earnings Shock
<b>Direct Impact on the Corporate Sector</b>			
Change in Uncovered Borrowing Ratio (UBR)	6.0	5.4	8.7
Change in Uncovered Bank Borrowings Ratio	8.2	6.1	11.1
Uncovered Bond Ratio	3.4	6.5	6.0
<b>Indirect Effect on Banking Sector</b>			
Increase in Bank SDL ratios	0.5–1.9	0.3–1.4	0.7–2.6
Reduction in Bank Basel Capital Ratios	0.2–0.7	0.1–0.5	0.3–1.0

Source: Staff estimates.

Notes:

- Interest rate shock: 2 percentage point increase in call rate and 1.24 percentage point increase in 3Y bond yield.
- Exchange rate shock: 20 percent decline in the net gains on foreign currency transactions and translations.
- Earnings shock: 20 percent decrease in operating income.
- Uncovered Borrowing Ratio (UBR) is the proportion of total industry debt for which the interest coverage ratio (ICR = EBITDA to interest expenses) is less than 0.75. A threshold of 0.75 was used instead of the standard cutoff of 1.0, since some Korean firms earn substantial interest income, and the threshold of 0.75 had greater explanatory power for describing corporate performance.
- Bank SDL ratio: The impact on the ratio of substandard, doubtful, and loss loans to total loans is calculated based on cross-sectional regression for 30 industry categories (for lower bound) and a regression of the total SDL ratio with the uncovered bank borrowings ratio (for upper bound).

### C. Other Short-Term Risks

43. In addition to the directly quantifiable risks discussed above, parts of Korea's financial sector can—even in short-term—suffer significant losses from structural weaknesses. In particular, the following areas would need to be highlighted:

- **Derivatives.** The Korean derivatives market was established only in 1996 but has since grown very rapidly.<sup>13</sup> Benefits include improved price formation, larger market liquidity, and more hedging possibilities. While the nature of instruments used and the level of exposures do not indicate at present any systemic risk, continued, rapid growth and prevailing market practices have raised concerns about additional risks for institutions that are engaging in this market (Box 2). While market participants have put in place reasonable risk management systems, the extent to which these have been sufficiently adapted to the Korean markets remains an issue. The need to supervise the rapidly growing area of derivatives and to adapt to the increasing level of sophistication is

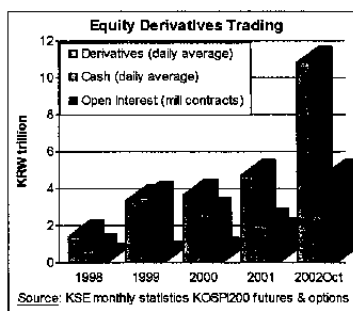
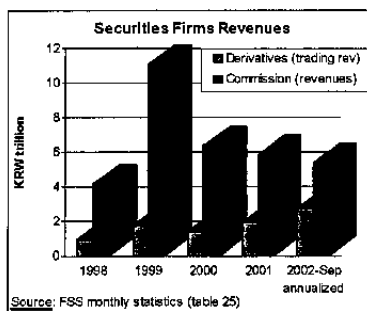
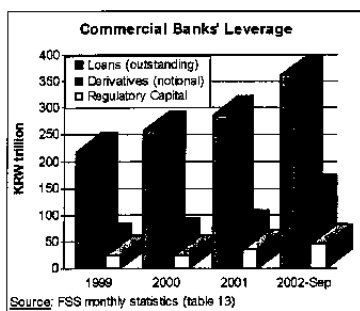
<sup>13</sup> The overall level of derivatives activities remains below OECD average. However, KSE was the single largest derivatives exchange in the world by number of traded contracts in 2001, even though contract size is smaller than in other markets.

## Box 2. Main Features of Korea's Derivative Markets

**Korean derivatives markets have grown rapidly but their overall size remains below OECD average.** Notional volumes in Korean over-the-counter (OTC) derivative markets have tripled from December 2000 to September 2002 to reach KrW 756 trillion (130 percent of GDP). Growth of exchange-traded derivatives (ETD) was even faster. Trading volumes in ETD instruments in the first half of 2002 exceeded KrW 1100 trillion, equally shared between equity and interest risk derivatives. Korean equity derivatives are now the largest in the world by number of contracts and rank among the top five by trading value. Retail investors account for 48 percent and securities firms for thirty eight percent of trading in equity derivatives markets.

**The main features of OTC and ETD markets are as follows:** The market for OTC derivative instruments in Korea is mainly made up of interest rate swaps in Korean won (KrW), cross-currency swaps and to a smaller extent, currency options, and credit derivatives. ETDs in Korea consist mainly of stock index (KOSPI 200) futures and options which are traded on the Korea Stock Exchange (KSE), and Korea Treasury Bond (KTB) futures and won/dollar futures which are traded in the Korea Futures Exchange (KOFEX). Trading is about four times of cash markets, and turnover is three times in equity and six times in bond markets.<sup>15</sup> The average number of daily KTB futures transactions rose from 6,300 in 2000 to 37,900 in 2001. Over the same period equity derivatives transactions increased by over eighty percent in trading volume.

**Korea's derivative markets may be subject to specific risks but efforts toward risk management are well advanced.** Large differences among individual banks and risk factors specific to emerging nature of the Korean derivative markets indicate that overall risks might be higher than OECD averages. Aggregate credit exposures of Korean banks' derivatives business are three percent of notional amounts as compared to one percent BIS average and 1.4 percent for Japanese banks. This could be due to structural differences in the portfolio composition of derivatives that point to Korean derivatives having a greater net market value sensitivity to changes in market parameters (such as exchange and interest rates), or higher net exposures because of differences in portfolio netting characteristics. Also Korea has a large share of (generally more volatile) currency derivatives that account for 38 percent of total outstanding notional amounts as compared to a BIS average of 14 percent, although currency forwards (that typically have maturities less than a year, and less exposure implications compared to longer-term currency swaps) account for a relatively large 22 percent share in Korea. Market participants have put in place reasonable risk management systems and are in the process of adapting them to the Korean market environment. Most OTC deals are undertaken based on ISDA master agreements and the authorities are undertaking efforts to clarify the legal validity of close-out netting to increase the current low level of reported netting.



<sup>1</sup> There are five companies with listed options on the exchange.

Table 6. Impact of Macroeconomic Shocks on Household Credit

	Baseline 2002 Est. (Percent)	No Policy Reaction (Change in percent/percentage points)	Demand Shock 1/	Supply Shock 2/
<b>Shock</b>				
Disposable income	...	-5.0	-3.5	-5.8
<b>Policy reaction</b>				
BOK target call rate	...	0.0	-1.5	0.5
Interest payments to income 3/	11.1	0.6	-0.3	0.9
Debt to income	115.0	6.1	4.2	7.0
Nominal effective interest rate 4/	9.6	0.0	-0.6	0.2
<i>Estimates based on Norges Bank Model</i>				
Delinquent loans/ household credit	1.2	6.2	0.0	8.7
BIS capital adequacy ratio 5/	10.6	-1.0	0.0	-1.5

1/ Assuming a reduction in BOK target call rate of 150 basis points to moderate growth reduction.

2/ Assuming a rise in BOK target call rate of 50 basis points to prevent inflation rising.

3/ Financial liabilities of the individual sector are projected to rise 30 percent, and disposable income by 7 percent compared with 2001, and the effective interest rate is assumed to fall by 50 basis points.

4/ The effective interest rate is estimated to respond with an elasticity of 0.4 to changes in the policy rate after two years.

5/ Assuming 1/3 of non-performing household loans are charged off against capital.

straining the FSS' scarce resources. Current low levels of close-out netting—a key instrument to reduce counterparty risk—are likely to increase following the authorities' efforts to clarify the legal basis.

- **Yen “carry trade.”** Interest rate differentials between yen and won and a degree of exchange rate stability have induced increased interest in yen borrowing. The FSS has taken important steps to ensure that banks adequately monitor implied credit risk and promote hedging. The authorities will also need to be mindful of the possible risks that might arise from short-term borrowing abroad by the corporate sector.
- **Securities firms.** The securities sector, which accounts for slightly more than 3 percent of financial sector assets, is structurally weak. Capital levels of some companies are low and securities firms appear pressured by declining brokerage income. In this environment, they take mostly similar leveraged positions, in part due to high usage of “program-guided trading.” Systemic risks could arise if the rapid growth of leverage continued amid high volatility, and if leading securities firms were to become dominant players, with all institutions having high risk exposures of a similar type. The authorities' recent decision to extend OTC derivative trading to only three well capitalized securities firms is a first step in the necessary process of strengthening prudential regulations and supervision over the sector.
- **Supervisory challenges:** While adequate in most places, some areas in the prudential oversight process seem stretched which could leave important risks undetected. Examples include the FSS's apparent difficulties in monitoring off-balance sheet exposures, which

have grown rapidly in the recent past. Insufficient information is available on connected lending and related party transactions, which were a major problem at the time of the crisis. Other issues include instances of late or incomplete availability of core supervisory data.

- **Residual risks from asset-backed securities (ABS).** A significant amount of NPLs in Korean banks' balance sheets have been securitized using ABS issues, some of which included credit enhancements provided by banks in case the security performed worse than expected. Appropriate disclosure and supervisory vigilance on the valuation and provisioning practices in the ABS market will be needed to monitor remaining bank exposures.
- **The weaknesses in the non-bank deposit taking financial sector are of concern.** While neither individually nor as a group systemically important, an eventual open crisis in that sector might nevertheless tarnish the reputation of the Korean financial system.
- **Weak ITCs.** Public awareness of the financial difficulties and the negative capital ratios of some large ITC companies are increasing. The main danger could lie in the loss of market confidence and, additionally, possible contagion to other segments of the financial market, in particular since the securities sector as a whole remains weak.
- **Delays in completing corporate restructuring.** Despite the progress made, corporate restructuring has failed to address the problems of about a quarter of the corporations, many of which have negative cash flow, are unprofitable and overleveraged, and are likely to fail. While those potential failures are probably smaller than the Daewoo and Hynix cases, they could be substantial in the aggregate, unsettle capital markets, and increase credit losses in financial institutions. The FSS mandated semi-annual review of "potentially ailing" companies based on EBIT/interest rate criteria needs to be implemented rigorously to further improve provisioning and to avoid "evergreening" and speed up restructuring.

#### IV. MEDIUM-TERM AND STRUCTURAL ISSUES

44. **The medium-term challenge for Korea's financial sector is to deepen markets, while ensuring that the supervisory and regulatory framework is capable of addressing any associated risks.** This section highlights the main areas that might need attention. In the legal and regulatory area there are important challenges such as ensuring the full independence of the regulator and providing a more efficient and predictable framework for insolvency. Medium-term financial stability will also require addressing structural soundness problems especially in the insurance and securities sectors. Furthermore, impediments to market development are an issue of concern. The further deepening of money, foreign exchange and bond markets all appear closely linked to supportive government debt management practices. Finally, improving corporate governance practices will enhance investor confidence—critical to all other areas discussed.



## **A. Financial Sector Supervision and Regulation**

45. **The FSC/FSS/SFC have established a track record of issuing rules and regulations, which have generally been appropriate and timely, but concerns about some aspects of the regulatory process remain.** In particular, market participants have questioned the quantity and quality of such regulations, the opaque way in which some of them have been introduced, their interpretation, and the fact that prudential regulators lack the unfettered right to issue new regulations when they perceive a need to do so. There is also a perception in the market that violations of applicable regulations are often overlooked or weakly sanctioned. Weak implementation of regulations or inadequate sanctions for violations undermine the integrity of the regulatory process and encourages further inefficient and inappropriate market behavior.

46. **Given the scope and power of the FSC/FSS/SFC, their independence is a matter of great importance.** Although embodied in the law, in practice independence has been called into question. Concerns arise because of the role taken by MOFE in interpreting laws and supervisory regulations, giving FSC/FSS/SFC only limited freedom in implementing supervision. In addition, the rapid turnover of the FSC chairman (who also is the governor of the FSS) and the policy where FSC staff would sometimes be moving to and from MOFE has a potential to undermine the credibility of supervisory independence.

47. **Supervisory effectiveness may also be hampered by the insufficient legal protection for FSC/FSS/SFC staff against lawsuits for supervisory actions.** While there are to date no reported difficulties, this could become an issue as Korea integrates more into the global financial system and participants become less bound by traditional Korean legal customs and procedures. Appropriate legal protection for supervisory staff would help to ensure that fear of retribution does not constrain supervisors when exercising their professional responsibilities.

48. **The FSC was also given, in addition to its role as regulator, responsibility for overseeing the restructuring in the corporate and financial sectors in the wake of the financial crisis.** As a result, it has been put in a position of having to compromise on occasion with what might be appropriate from a purely prudential perspective. Whatever the merits of this assignment of responsibility at the time, corporate and financial restructuring should now be carried forward by the private sector or in the case of government-owned entities by the agency holding the shares.

49. **The FSC/FSS/SFC appear to have sufficient well-trained staff to carry out their responsibilities, but there are indications of shortages of expertise in a few key areas.** Additionally, there are some concerns about the ability of the supervisor to maintain the technical capacity of staff through ongoing recruitment and training in an increasingly complex and competitive financial system. This situation also reflects a national shortage of key professionals. Some efforts are under way to reduce these shortages over time, and other efforts might be considered.

50. **Some market participants have voiced concern that prudential supervision is not applied equally, and that there is excessive intervention of the supervisor in day-to-day management.** Market participants also note that the complex regulatory framework makes

full compliance with all requirements impossible, leaving them exposed to inconsistent application of fines and retribution. The authorities should continue their efforts to make the sanctions process open and transparent, and be mindful of the need to avoid perceptions of unequal treatment and of unjustified retribution.

## **B. Legal Infrastructure**

51. **Korea has established a sound and respected judiciary and judicial system.** Judges are well regarded and considered competent and impartial. In the area of commercial disputes including insolvency, the authorities have strengthened the ability of the courts to respond to the needs of the financial and corporate sectors. Court procedures have been streamlined, although further reforms would help to overcome some concerns regarding perceived delays in the court system, the ability of a creditor to issue attachment proceedings on an *ex parte* basis, and the relatively unfettered right of any party to appeal or to seek adjournments.

52. **The scope and pace of legislative reform following the 1997–98 financial crisis has been extraordinary.** New laws dealing with particular aspects of financial and corporate restructuring and other specialized areas of financial sector reform have been introduced and new institutions were created. Several of these laws have been amended, reflecting the authorities' readiness to fill identified gaps in the legislative and regulatory framework. However, the framework in place is, in certain areas, complex and has resulted in some overlapping responsibility and uncertainty as to lines of authority—particularly in relation to regulatory supervision—and in some tension between regulatory bodies.

53. **The legal framework for secured transactions is generally sound.** Company, movable and immovable property registers work well and debt enforcement mechanisms are relatively straightforward. However, there is no provision for non-possessory pledges such as the right to secure inventory and accounts receivable. The introduction of such rights together with a comprehensive review of the secured transactions regime as an alternative to insolvency should be considered.

54. **A preliminary assessment of the proposals for insolvency reform confirms that the authorities are moving in the right direction.** However, the delay in adopting this reform is unfortunate. The adoption of a single unitary law which also addresses consumer rehabilitation and cross border insolvency would be a welcome development. However, an improved legal framework is desirable but not sufficient. Of perhaps even greater importance will be the attitude that creditors take to the new regime and whether they will use it effectively to restructure weak companies and promote solid corporate financial health.

## **C. Sectoral Issues**

### **Banking sector**

55. **The government has made encouraging strides to return banks under its control to private ownership.** It has found creative ways to place parts of Woori and Chohung in the market and make a number of contingent sales. However, the process remains to be completed. The merger of Hana Bank with Seoul Bank has left the government with a 31 percent equity stake in the merged bank, which accounts for 12 percent of banking sector

assets. In addition to selling this stake, the sales of Woori, Chohung and minority stakes in KEB, KFB, and Kookmin Bank are still pending. Full divestiture would eliminate potential conflicts of interest arising from the government's role of both regulator and owner of banks.

56. **As part of its restructuring policy, banking concentration was actively pursued by the government since 2000.** These efforts helped increase efficiency and reduced the number of non-viable banks in the system. However, against the background of a now profitable sector, the market, rather than the government, seems better placed to determine the structure of the banking system over time. Despite the increased concentration in the sector, competition in both deposit and loan markets remain healthy. Consumer protection and competition policy should remain important concerns for the authorities, but they should be implemented in a way that allows for innovation.

57. **Special privileges granted to some specialized and development banks undermine market competition.** For instance the IBK, the KDB, and the banking sections of the National Agriculture Credit Federation (NACF) and National Forestry and Fisheries Corporation (NFFC) carry out operations typical of commercial banks, such as deposit taking, lending, trust business, and credit card operations. They enjoy benefits that include some combination of low cost funding through government guarantees, borrowings from the government and the BOK, as well as preferential treatment regarding some prudential ratios, such as liquidity. The IBK is a main competitor in its SME lending business with many mid-sized commercial banks who do not share the same funding and guarantee privileges. It would be appropriate to level the playing field by phasing out any privileges that differentiate across financial institutions.

### **Insurance and pensions**

58. **The principal concern for the insurance sector is the capitalization of the life insurance companies.** The industry is, at best, marginally capable of meeting the current minimum capital requirements once they are fully phased in. A more robust valuation of liabilities, exclusion of double counting of regulatory capital in subsidiaries, and an additional margin for the substantial market risk arising from the asset liability mismatch and exposure to equities would place many companies in a marginal situation. Many of them will have access to capital from their parent, and the regulatory and supervisory regime should require the allocation of this capital to the life insurance business. Others may need closer supervisory intervention. The prudential status of companies would also be enhanced if the impediments to listing were overcome.

59. **The role of the Korean Insurance Development Institute (KIDI) raises some concerns.** While useful in the ongoing development of the sector, the extent of the continuing role in, for example, product development and approval may discourage individual company innovation and company development of in-house technical expertise. The procedures and basis for decisions within the KIDI are not transparent to industry participants. The functions and operations of the KIDI should be refined and refocused to enhance their transparency and flexibility, in concert with a system that further encourages companies to develop advanced risk management systems.

60. **The government is involved in the insurance sector through its continuing part ownership of Korea Life via the KDIC, and the operations of the ‘quasi-insurance’ sector.**<sup>14</sup> The marked lack of transparency in the “quasi-insurance” sector operations contributes to suspicion from the commercial sector. More transparency would be consistent with the stated public benefit objectives of the “quasi-insurance sector” and facilitate a more soundly based consideration of the merits of its continued operation in its present form.

61. **Pension reform is recognized as necessary given the aging of Korea’s population and the general level of funding of the current arrangements.** The authorities are to be commended for the priority they have attached to these initiatives to date and should continue these efforts, both in terms of the proposals for an occupational pension system in the private sector and for the continued careful consideration of the role and sustainability of the national pension system. The introduction of an occupational pension system will require the establishment of a well considered regulatory and supervisory regime. The effort needed to achieve such a regime should not be underestimated.

62. **Regulators should devote close attention to the introduction of bancassurance.** Early attention will need to be given to the potential existence of capital and other regulatory arbitrage and differential taxation treatment of product providers. This would ensure that any refinements can be made whilst transitional issues are at a minimum.

#### **Fund management and securities**

63. **Securities markets are characterized by high retail participation and significant trading by securities firms on their own account.** In contrast, sizeable actively trading institutional investors are all but absent. This market structure has contributed to high volatility in equity markets and rapid growth in speculative derivatives trading. There are also weaknesses in the investment trust industry, where some companies have negative capital.

64. **Higher participation of institutional investors in Korea’s security markets would greatly benefit the stability and development of that market.** Such investors promote long-term savings, enhance productivity and innovation, emphasize trust and corporate governance, and often become strategic investors. Although Korea has introduced a variety of collective investment vehicles (including bank trust accounts, investment trust and management companies, investment advisory firms, corporate-style mutual funds, and contractual savings) the fund management industry has not yet been able to rebuild investor trust. Industry experts suggest that the form of investment trusts (ITC) is suitable for Korean markets, but that corporate governance must be enhanced emphasizing independence, both

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<sup>14</sup> Fifty-one percent of Korea Life have been sold in October 2001. The Agricultural Cooperative Life Insurance and the Postal Life Insurance operations together account for 16.5 percent of new business by policies and premium, 23.5 percent of in force premium income, and 18.8 percent of total sector assets.

from government and corporate or sell-side pressures.<sup>15</sup> Moreover, the market requires substantial consolidation. In addition, new legislation on fund management should emphasize market principles and provide safeguards for independence, such as mandatory monthly disclosure of assets, and strict separation between managers and trustees.

### **Corporate restructuring**

65. **While the corporate failures associated with the 1997–98 crisis prompted several waves of corporate restructuring, the agenda remains unfinished.** Korea has succeeded in increasing overall profitability of the corporate sector, in addressing long-term moral hazard issues, financially stabilizing distressed companies, in initiating follow-on operational restructuring, and in improving transparency in financial disclosure and corporate governance. However, three main risks remain: (i) In 2001, the bottom quartile of Korean companies showed very high leverage ratios, large net losses, and low interest coverage. Although Hynix and other large companies are being restructured by creditors, they remain exposed to the risk of further losses. (ii) The prospects for many of the smaller companies emerging from workouts are uncertain. Almost half of the smaller public companies in workouts remain unprofitable and most are still highly leveraged. (iii) Weaknesses in financial disclosure and corporate governance may permit insiders in Korea's largest chaebols to channel financial support from strong to weak affiliates, at the expense of the stronger affiliates (and outside shareholders).

66. **Given the risks associated with delays in corporate restructuring, care needs to be taken to minimize possible spillover effects on the financial sector.** Measures in that regard include encouraging efforts by financial institutions to identify emerging cases of corporate distress and initiate needed financial and operational restructuring in a timely manner, based on forward-looking criteria for the classification. Financial institutions will need to move forward aggressively with restructuring of distressed-but-viable companies, and to pursue prompt sale or liquidation of non-viable companies. Owners and supervisors will need to prevent financial institutions, especially state-owned banks, from delaying loss recognition on over-valued corporate assets. The FSC/FSS should ensure that financial institutions value workout companies at market value. Efforts to strengthen corporate governance and the insolvency regime will support the financial sector's ability to engage in new corporate lending activities.

### **D. Market Development Issues**

67. **Korea has active money, bond and foreign exchange markets, but further market development hinges upon overcoming some related structural problems.** These include insufficient ability to build a yield curve in won assets, which reduces the liquidity of money markets, with possible effects also on investors' ability to hedge activities in the foreign exchange market. In addition, the insufficient volume of longer term government

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<sup>15</sup> The ownership of an ITC by a securities firm could lead to conflicts of interest and a weak financial base, whereas the opposite structure (the ownership of a securities firm by an ITC) or a holding company structure is more common internationally.

bonds constrains the deepening of the corporate bond market. Government debt management practices, including the choice of types and maturities of instrument offered, can play a critical role in market development.

### **Money and foreign exchange markets**

68. **Korea's short-term money market suffers from some shortcomings.** A lack of instruments prevents the determination of the short-term end of the risk-free yield curve between the overnight and one-year maturities. This complicates the determination of a prime rate that could use for pricing of loan contracts and forward foreign exchange transactions. In addition, it impedes the effective transmission of monetary policy to the longer end of the yield curve. Regular issuance of three-month Treasury bills would help to meet these needs without constraining the use of MSBs for monetary purposes.

69. **One problem recognized at the time of the financial crisis was the lack of liquidity in Korea's foreign exchange markets.** The authorities should be commended for the substantial efforts that they have taken since then to develop and deepen the liquidity in the foreign exchange market. Indeed, this market has improved significantly over the last three years in terms of liquidity and available instruments. Nonetheless, further steps to deepen it should be considered.<sup>16</sup>

### **Public debt management issues**

70. **Despite important improvements in government debt management, the market remains fragmented.** In addition, maturities demanded by the markets—most notably a three-month bill that would help deepen money markets, and a longer term bill that is in high demand by institutional investors—are not issued or issued in insufficient amounts. A review of debt management practices suggests that there may be room to further lower the cost of government borrowing, while at the same time supporting the development of deeper money and corporate bond markets.

71. **On the whole, public debt management is in line with the Guidelines for Public Debt Management.** The risk management framework has been strengthened with the implementation of a simple, yet powerful system. The authorities may now wish to consider broadening the risk management framework towards an asset-liability management (ALM) approach.

72. **The government bond market modernization plan launched two years ago has had important results.** The introduction of a fungible issuance system and the buy-back operations have increased the average issue size and liquidity. The government has also launched a new 10-year Korean Treasury Bond (KTB). Furthermore, interest rate swaps and a futures contract based on the 3-year KTB have been introduced as hedging instruments for KTBs.

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<sup>16</sup> Some measures are already envisaged in the foreign exchange liberalization plan to be completed by 2011, but there may be scope for accelerating some of them.

73. **There is scope to develop the long end of the government bond market.** In the long run, such lengthening can lower the government's borrowing costs, and more importantly, facilitate the emergence of a fully developed and liquid corporate bond market. Consolidating Foreign Exchange Stabilization Bonds and National Housing Bonds with KTBs would help in reducing market fragmentation, starting in 2003 with KDIC and KAMCO bonds.

74. **On the demand side, there is a clear need for more heterogeneous investors with different investment horizons and risk preferences.** The National Pension Fund with its growing demand for assets could be a major force in the market. In addition, more active participation of foreign investors would also be helpful. This would have two main benefits: higher long-term demand for Korean government bonds and enhanced market liquidity from more active trading. The fact that foreign investors presently hold only 1 percent of the outstanding stock of government bonds suggests the existence of impediments to foreign investor participation in the market. Such impediments could include the withholding tax on interest income and the restrictions a foreign investor meets when trying to hedge foreign exchange exposure. Constraints related to the still relatively shallow secondary market may, however, be the most important disincentive.

#### **E. Financial Safety Nets and Crisis Management Capabilities**

##### **Liquidity support in normal times**

75. **Short-term money markets are sufficiently liquid to allow banks access to market liquidity in normal times.** In addition, the BOK has adequate facilities to manage overall liquidity and assist banks in meeting temporary shortfalls. It intervenes in the money market through repo transactions or the issuance/redemption of MSBs. Reserve requirements averaging also helps banks' liquidity management. Finally, the BOK has a number of credit facilities to complement open market operations.

##### **Emergency liquidity**

76. **The BOK Act provides sufficient flexibility for the BOK to provide emergency liquidity assistance (ELA) to financial institutions in periods of instability.** It allows for collateral to be "temporarily defined as acceptable" and gives the BOK authority to restrict the activities of the borrower while there is ELA outstanding.

77. **The BOK provided extensive ELA during the financial crisis but operations in the post-crisis framework remain untested.** During the crisis, ELA assistance proved critical in containing the systemic liquidity crisis. However, the BOK's ELA operations at that time were conducted when the government blanket guarantee on bank liabilities was still in effect, which is no longer the case. Looking forward, therefore, there could be new challenges for the BOK ELA operations, should a need for such lending arise again. The BOK is aware that any ELA operations in an environment of partial deposit insurance would subject the central bank to higher credit risks.

78. **Given the separation of banking supervision from the BOK, assessing the systemic implications of a bank failure may be harder.** Thus, there is a need for the BOK and the FSS to strengthen their information sharing arrangements. While the recent

memorandum of understanding (MOU) between the BOK and the FSS is a useful step in that direction, care needs also to be taken not to duplicate on-site inspections.

79. **On-going market consolidation will produce large financial institutions with complex organizational structures, where banks and non-bank financial institutions have inter-linkages and share common reputational risks.** How to deal with such large and complex financial institutions in ELA operations should receive due attention. Moreover, as capital markets develop further, the liquidity situation of non-bank market intermediaries could have significant impact on overall market stability. Dealing with such potential contingencies is also a challenge for the authorities. The MOU between the FSS and the BOK is a welcome step in this process.

#### **Deposit insurance and resolution of financial institutions**

80. **The Korea Deposit Insurance Corporation (KDIC) in cooperation with the Korea Asset Management Company (KAMCO) has been instrumental in resolving distressed financial institutions, and in paying depositor claims.** This was done under the blanket Deposit Protection System that was put temporarily in place during the crisis. With the reinstatement of the Partial Deposit Protection System from January 1, 2001, KDIC's role has broadened, from *ex post facto* deposit insurance provider, repaying deposits in the event of default, to include expanded responsibilities in monitoring and safeguarding the financial stability of insured deposits and the Deposit Insurance Fund.

81. **The KDIC has already significantly improved its organizational structure to address its changing role.** To safeguard the insurance fund it is considering the introduction of risk-based premiums and the development of risk assessment models to detect potential problems at individual institutions and the system as a whole. While in principle welcome—once preconditions have been met—the introduction of risk-based premiums is a demanding exercise and should be approached with caution, since inadequate implementation could have undesirable consequences.

82. **The KDIC has proposed an amendment to the Deposit Protection Act to cease insuring credit unions.** The National Credit Union Federation of Korea plans to establish a private deposit insurance system for its members. The authorities should proceed with caution until all nonviable institutions are resolved, to avoid the possibility of runs.

83. **The existing safety net and resolution arrangements date from the 1997–98 crisis.** In light of the changed environment, the roles of the different institutions concerned may now need to be reviewed, to set clear responsibilities to all those institutions and establish contingency planning for crisis management. The Financial Policy Coordination Committee could serve to identify priorities and establish guidelines for such planning. In assessing the respective roles of FSC/FSS, BOK, MOFE, and the KDIC arrangements for crisis management, coordination and frequent information sharing between these institutions should take precedence, perhaps through committees that establishes guidelines and procedures for early action, and meets regularly should symptoms of a systemic crisis emerge.



## F. Corporate Governance

84. **In the last few years, Korea has laid a solid foundation for good corporate governance.** However, while formal corporate governance rules may now be substantially similar to other OECD countries, practices often fall short of the spirit, if not the letter, of the OECD principles. The challenge now lies in implementation and effective enforcement of legislative changes to improve the corporate culture and practices. The government and the business community should take additional steps to change incentives and further promote transparency of business practices, particularly among chaebol groups; to strengthen competition policies, in order to subject chaebol and firms to stricter market discipline; to enhance and enforce shareholder rights; and to improve disclosure and monitoring of related-party transactions.

85. **To deepen its equity market, Korea needs to continue improving corporate governance practices in a manner consistent with other OECD countries and international best practice.** While there has been good progress in upgrading accounting and auditing standards, efforts should continue to further improve accounting standards and their implementation to make them fully consistent with evolving international practices. Efforts in 2002 to step up enforcement of accounting and disclosure standards and the preparation of a draft accounting bill are welcome steps. In addition, Korea should also continue to improve the effectiveness of audit committees, including measures to clarify and strengthen the role and function of such committees; replace statutory auditors with audit committees for smaller companies over time; and upgrade the skills of audit committee members.

86. **Holding companies, which would be more transparent than chaebol, are allowed, but not many have been established.** To improve transparency of large chaebol, several measures could be considered, including some that may provide incentives for such entities to transform into holding companies.

87. **Shareholder rights have been improved significantly to allow reduced levels of shareholding for assertion of certain rights, but further improvements are required.** While derivative actions are allowed, these are costly and therefore have been limited so far to only a few. Shareholders lack a cost-effective way to seek redress. There is an urgent need to introduce class action lawsuits by shareholders and investors against directors, managers, and auditors for breaches of duty and violations of the law. The draft law submitted to the National Assembly to allow class action lawsuits should be enacted as soon as possible.

88. **The concept of independent (outside) directors is new and still not well rooted in Korea.** Directors may not know what is expected of them and how they should exercise their duties. There is an urgent need to establish an institute of directors to train directors on their duties, responsibilities, and accountabilities.<sup>17</sup> Additional efforts could include measures to expand the fiduciary duty of directors to shareholders and make it explicit under the law; further expand and clarify the right of directors to access all corporate information necessary

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<sup>17</sup> One training course for directors has recently started, a second one is under preparation.

to perform their duties; and limit liability of independent directors in cases in which they have acted in good faith.

### **G. Combating Money Laundering and the Financing of Terrorism**

89. **Korea has made considerable strides towards observance of the Financial Action Task Force's (FATF) recommendations on combating money laundering and the financing of terrorism.** Korea's Financial Intelligence Unit (KoFIU) joined the Egmont Group in June 2002, and its computer database became recently operational. A system for the strategic analysis of suspicious transactions will also become operational this year. Underscoring Korea's commitment to AML/CFT, it submitted in August of 2002 to an on-site examination by the Asia Pacific Group of the framework it has set in place to combat these activities. Nonetheless, further efforts are warranted among others in the following areas: First, expediting the enactment of the Anti Terrorism Bill, consistent with the United Nations International Convention for the Suppression of the Anti- Terrorism of 1999. Second, the limitation of the Real Names Act on access to customer information should be addressed in order to facilitate international cooperation in the investigation of money laundering and financing of terrorism cases. Third, the monetary threshold for suspicious transaction reports should be abolished as soon as is practicable.

## SECTION II—REPORT ON OBSERVANCE OF STANDARDS AND CODES

### I. SUMMARY ASSESSMENT OF OBSERVANCE OF THE BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

#### A. General

90. This assessment of the bank supervisory system in Korea was performed on the basis of the *Basel Core Principles for Effective Banking Supervision* and the *Basel Core Principles Methodology*.<sup>18</sup> It was based on a review of the legal framework governing banking and bank supervision and extensive discussions with government and supervisory agencies, representatives of financial institutions and financial sector associations. The assessment also drew upon a partially completed self-assessment prepared by the Korean authorities.

91. **Bank examination reports and other bank-specific analysis were not made available to the assessment team at the time of the mission,** due to the Financial Supervisory Commission (FSC) and the Financial Supervisory Service (FSS) concerns regarding confidentiality. In subsequent discussions after the BCP mission, the staff of the FSC/FSS offered to provide access to confidential materials.

#### B. Institutional and Macprudential Setting, Market Structure—Overview

92. **As of mid-2002, the banking sector included nine nationwide commercial banks, six regional banks, five specialized and development banks, and 42 foreign bank branches.** The Korean banking sector is highly concentrated and at present, following crisis-related interventions, dominated by the government. The share of the three and five largest banks stood at 51 and 69 percent of total sector assets, respectively. Eight out of 15 commercial banks are either majority government owned or co-owned by the government and private owners. When combined with government-ownership in specialized and development banks, in mid-2002 nearly 60 percent of the assets of the Korean banking sector is government-controlled. The government is pursuing active efforts towards privatization.

#### C. General Preconditions for Effective Banking Supervision

93. **Presently, Korea's macroeconomic management has delivered sound and sustainable policies, and the public sector infrastructure is well-developed, with a significant body of recently-revised laws covering the financial sector.** The FSC, with the associated FSS and SFC, is an integrated supervisor, responsible for the regulation and supervision of the financial sector. Its powers include the authority to issue and revoke

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<sup>18</sup> The assessment took place in April 2002 as part of the IMF-World Bank Financial Sector Assessment Program (FSAP). The team was led by Ms. Greta Mitchell Casselle (Monetary and Exchange Affairs Department, IMF), Mr. Alan Ball, (banking supervision expert from the Financial Services Authority, United Kingdom), and Ms. Chu Yun Pae (banking supervision expert from the U.S. Federal Reserve Bank of San Francisco).

licenses for financial institutions. In addition, it has some responsibilities for corporate sector restructuring.

94. **The power to define the scope of banking activities is vested in the Ministry of Finance and Economy (MOFE). Decisions regarding corrective action for problem banks rests with the FSC, the policy body, and not the FSS, the executing body.** Once decisions are taken by the FSC and a framework for remedial action is developed, it is implemented at the operational level by the FSS. Under the general direction of the FSC, the FSS supervises financial institutions (via on-site examinations and off-site monitoring) and other participants in the financial markets. In addition to FSC/FSS, the MOFE, the Bank of Korea (BOK) and the Korea Deposit Insurance Corporation (KDIC) also have some involvement in the examination/supervisory process.

95. **The legal machinery in place in Korea to support banking activities includes a relatively efficient court system. Korea is not fully compliant with International Accounting Standards (IAS),** with differences due to the absence or incompleteness of rules governing related party disclosures and disclosures by banks and similar financial institutions. A new accounting standard for the banking industry is being drafted, which will be fully consistent with IAS. With respect to corporate governance, there is scope for strengthening market discipline by implementation of IAS and enhancing financial transparency for corporations. The Korean financial system is supported by a comprehensive public safety net and an explicit deposit insurance system.

#### **D. Main Findings**

96. ***Objectives, Autonomy, Powers, and Resources (CP 1).*** The operational independence of the FSC/FSS is embodied in law, however in practice several factors have called that independence into question. To protect the operational independence of FSC/FSS, the MOFE should allow laws in the financial sector to be implemented by regulation, to the greatest extent possible, and refrain from issuing its own interpretations of those regulations. The FSC's responsibility for overseeing the financial restructuring program compromises its primary role as bank supervisor, and should, therefore, be vested with another agency. Measures should be taken to clarify responsibilities between the FSC and the FSS and between the FSC/FSS and the BoK and KDIC and. Finally, the FSC and the FSS should address key staffing issues that could potentially undermine their effectiveness, i.e., the lack of statutory protection for the FSC/FSS and their staff against lawsuits; the frequent turnover of the Chairman of the FSC; and the lack of adequate examination staffing resources to carry out supervision duties.

97. ***Licensing and Structure (CPs 2-5).*** The FSC/FSS lacks regulatory authority to determine the scope of permissible banking activities. Additionally, the legal framework and supervisory powers with respect to the licensing processes should be strengthened. The FSC/FSS should apply fit and proper test to employees below Board level, corporate ownership of banks should be subject to rigorous fit and proper tests, and the licensing of banks should be void of political interference.

98. ***Prudential regulation and requirements (CPs 6-15).*** Capital requirements for banks are broadly in line with the Basel capital standard, but there is need for the FSC/FSS to use

flexibility in the application of capital adequacy ratios above the defined minimum. For banks, there is scope for strengthening and clarifying comprehensive loan evaluation methodologies and adherence to provision criteria, large exposure and concentration limits and transactions between insiders. The FSC/FSS also needs to strengthen their supervisory practices and banks' capital and risk management techniques for off-balance sheet derivative exposures, and other risks. In terms of anti-money laundering legislation, the FSS needs to finalize and fully implement its internal procedures for ensuring compliance with the new legislation. The FSC/FSS needs to strengthen the prudential rules such as capital and asset classification norms for nonbank deposit-taking institutions, to bring them in line with rules for banks.

99. **Methods of ongoing supervision (CPs 16-20).** There is a need to further develop risk-focused supervision examination techniques (scope and periodicity) for each type of bank and other nonbank deposit-taking institutions, consolidated supervision of financial holding companies, and improve the quality of supervisory data management.

100. **Information Requirement (CP 21).** The quality of auditing, accounting, and financial and non-financial disclosure needs to be further improved in order to be consistent with best international practices.

101. **Formal Powers of Supervisors (CP 22).** There is a full range of remedial actions that can be taken against banks. However, there is scope to strengthen and clarify the FSS' powers to initiate enforcement actions.

102. **Cross-Border Banking (CPs 23–25).** While the FSC/FSS undertake consolidated supervision on a global basis, provisions of the *Real Name Transactions Act* have the potential to prevent an unimpeded exchange of information with foreign supervisors.

Table 1. Recommended Action Plan to Improve Observance of the Basel Core Principles

Reference Principle	Recommended Action
Objectives/Autonomy of Supervisory Agency (CP 1)	<ul style="list-style-type: none"> <li>• Strengthen the operational independence of the FSC/FSS by allowing laws in the financial sector to be implemented by regulation. The MOFE should refrain from issuing its own interpretations of those regulations. Undertake measures to ensure that the operation of MOFE and the RRC in interpreting and reviewing decrees, regulations, and rules do not hinder the operational independence of the FSC/FSS.</li> <li>• Clarify the role of the FSC/FSS as the main supervisory body in its dealings with other government agencies (e.g., the KDIC, the BOK, and the MOFE), preferably through MOUs.</li> <li>• Take measures to bring about continuity of the chairmanship of the FSC.</li> <li>• Amend the <i>Banking Act</i> to give supervisors protection for actions performed while discharging their duties in good faith, and protection against the costs of defending their actions while discharging their duties.</li> </ul>
Permissible Activities (CP 2)	<ul style="list-style-type: none"> <li>• Empower FSS to define permissible banking activities.</li> </ul>
Licensing Criteria (CP 3)	<ul style="list-style-type: none"> <li>• Develop a comprehensive list of fit and proper qualifications for executive officers of banks and financial holding companies.</li> <li>• Process licensing requests based on the results of the vetting processes performed by the FSC/FSS.</li> </ul>

Reference Principle	Recommended Action
Ownership (CP 4)	<ul style="list-style-type: none"> <li>Strengthen the fitness and proper tests for owners and managers of banks.</li> </ul>
Capital Ratios (CP 6)	<ul style="list-style-type: none"> <li>Set minimum individual capital ratios to banks in relation to the risks run by each bank.</li> </ul>
Loan Evaluation and Loan-Loss Provisioning (CP 8)	<ul style="list-style-type: none"> <li>Strengthen supervisory review of loan evaluation and loan loss provisioning. Ensure the consistent and transparent application of FLC and urge banks to classify and provision rigorously FLC. Impose FLC for bank subsidiaries (sub prime lenders).</li> </ul>
Large Exposure Limits (CP 9)	<ul style="list-style-type: none"> <li>Monitor geographical concentrations and banks whose large exposures are in excess of the maximum limits and develop alternative plan of actions should they continue to exceed the prescribed limits.</li> <li>Review prudential norms for credit and large exposures to ensure that they appropriately capture all claims and transactions, both those on-balance sheet as well as off-balance sheet.</li> </ul>
Connected Lending (CP 10)	<ul style="list-style-type: none"> <li>Amend the <i>Banking Act</i> and subordinated statutes to include the arm's-length standard governing loans to insiders and to give the FSC/FSS the discretion to make judgments about the existence of connections between the bank and other parties.</li> </ul>
Market Risk (CP 12)	<ul style="list-style-type: none"> <li>Continue the development of supervisory and regulatory framework for measuring, monitoring and controlling market risk. Review the supervisory process and procedures in response to the rapid growth in derivatives and other off balance sheet activities.</li> </ul>
Other Risks (CP 13)	<ul style="list-style-type: none"> <li>Ensure that the regulatory authorities have a full understanding of a bank's overall asset and liability maturity position.</li> <li>Consider advancing the implementation of Basel II to introduce minimum individual capital ratios for banks, which reflect other risks (operational, reputational, liquidity, and banking book interest rate risk).</li> </ul>
Money Laundering (CP 15)	<ul style="list-style-type: none"> <li>Issue clear guidelines to banks setting out their statutory responsibilities under Articles 4 and 5 of the new <i>Financial Transaction Reporting Act</i> (FTRA).</li> <li>Ensure that all on-site examinations of banks and other deposit-taking institutions include a review of compliance with the requirements of the FTRA.</li> </ul>
On-Site and Off-Site Supervision (CP 16)	<ul style="list-style-type: none"> <li>Implement fully risk-based supervision. Perform transaction testing only as a tool to validate the systems and processes in place.</li> <li>Commission a study to determine the root causes of material deviations from the internal examination schedule and to assess current staffing and supervision needs, to ensure that staff levels remain commensurate with changing supervision needs.</li> <li>Develop and formalize a mandated on-site examination program for each bank and nonbank deposit-taking institutions, setting out the coverage, timeframe, and periodicity of the examinations. Apply comprehensive examination approach to government-owned specialized banks instead of using a different rating system. Improve the quality of data management.</li> </ul>
Off-Site Supervision (CP 18)	<ul style="list-style-type: none"> <li>Review practices for data collection to ensure that the frequency of information collected from banks vary by the nature of the information requested, and the size, activities, and risk profile of the individual bank.</li> </ul>

Reference Principle	Recommended Action
Consolidated Supervision (CP 20)	<ul style="list-style-type: none"> <li>• Strengthen consolidated supervision for nonbank deposit-taking institutions and for FHCs by amending the FHC Act to include managerial and financial strength and intercompany transactions norms (and require all FHCs to develop and implement policies and procedures to cover such transactions); and to prohibit the parent financial holding company and/or nonbank subsidiary from posing undue hardship on the bank subsidiary.</li> <li>• Impose consolidated supervision rules on bank subsidiaries (sub prime lenders) to reduce regulatory arbitrage opportunities.</li> </ul>
Accounting Standards (CP 21)	<ul style="list-style-type: none"> <li>• Assess the implementation of new accounting and auditing standards to ensure that their application is consistent with international standards and best practice.</li> </ul>
Remedial measures (CP 22)	<ul style="list-style-type: none"> <li>• Enforce PCA or other forceful measures to remove weak and insolvent non-bank deposit-taking financial institutions.</li> <li>• Delegate the day-to-day levying of penalties and administrative corrective measures to FSS, leaving major decisions such as de-licensing and intervention to the FSC.</li> <li>• Strengthen and clarify the powers of the FSC/FSS to remove employees of financial institutions.</li> </ul>
Globally Consolidated Supervision (CP 23)	<ul style="list-style-type: none"> <li>• Conduct a formal assessment of the quality of supervision in the countries in which Korean banks wish to operate.</li> </ul>
Host Country Supervision (CP 24)	<ul style="list-style-type: none"> <li>• Reexamine the existing interpretation of the <i>Real Names Act</i> and if necessary seek a statutory amendment to ensure an unimpeded exchange of information between supervisors.</li> </ul>
Supervision Over Foreign Banks' Establishments (CP 25)	<ul style="list-style-type: none"> <li>• Assess the quality of management of local branches and subsidiaries of foreign banks on the same basis as domestic banks.</li> </ul>

### E. Authorities' Response

103. While the authorities recognize shortcomings with compliance with other BCPs, they believe that measures are in progress to strengthen compliance. In some cases, they note that existing practices limit potential exposures that could result from weaknesses identified through the BCP assessment. With respect to operational independence of the FSC/FSS, the authorities indicated that the lack of clarity in the roles of agencies overseeing the financial sector promotes an effective system of checks and balances. On legal protection for supervisors, the FSS also noted that it covers legal expenses for both civil and criminal lawsuits brought against FSS officers and staff for actions taken while lawfully discharging their official duties.

## II. SUMMARY ASSESSMENT OF OBSERVANCE OF THE INSURANCE CORE PRINCIPLES

### A. General

104. This assessment of Korea's observance of the International Association of Insurance Supervisors (IAIS) *Insurance Core Principles* involved the review of the self assessment prepared by the Financial Supervisory Commission (FSC) and the Financial Supervisory Service (FSS), comparison with the *Core Principles* and the *Core Principles*

*Methodology*, and a review of parts of the insurance laws in Korea.<sup>19</sup> In addition, a series of meetings and presentations were held in Seoul with the FSS and the FSC, including discussions on all aspects of their operations relevant to insurance supervision. Meetings and discussions were also held with representatives of the Ministry of Finance, selected larger and smaller insurers, both locally incorporated and branches. Industry groups were also consulted including the insurance industry bodies, the Korea Insurance Development Institute (KIDI), the actuarial body, auditors and academics. Assistance provided by these organizations is gratefully acknowledged.

105. The supervisory staff at the FSS and the FSC cooperated fully in the assessment.

### **B. Institutional and Macprudential Setting—Overview**

106. **In 2000, the Korean insurance market had total premiums of \$58.3 billion, representing 2.3 percent of the world market, placing Korea as the seventh largest insurance market by premium in the world.** Premia as a percentage of GDP stood at 13 percent—well above most other countries and third behind South Africa and the United Kingdom. The comparisons of these figures with other countries are, however, complicated by the substantial savings element in non-life insurance business in Korea and the existence of relatively short-term life insurance policies.

107. **The sector has emerged from a difficult period after the crisis.** The life insurance sector, in particular, was hard hit by the effects of the crisis and the extensive exposure to negative spreads on in-force business. A number of companies left the market as a consequence, and one company converted to state ownership. Current circumstances are more positive as a result of restructuring, improved regulation, and increased profitability arising from restored consumer confidence and the asset price appreciation. It is cautionary to note that the structural issue that gave rise to negative spreads has been mitigated but not eliminated, and therefore continued prospects for the sector rely on continuing economic strength and asset growth.

108. **The Korean non life insurance market is the tenth largest in the world.** There are 22 companies operating as at December 2001, made up of 14 domestic and 8 foreign companies. Premium income in the year to March 2001 was W 16,478 billion. The market writes most classes of business, with the largest proportions of premia written in long-term insurance (42 percent in 2000) and automobile (39 percent).

109. **The Korean life insurance market is also large in size and ranks sixth in the world. Life insurance premiums were just under 10 percent of GDP in 2000.** The main products written are traditional endowment and whole of life insurances and various types of rider benefits. Unit linked insurance has recently been introduced and is growing. There are 22 companies operating in this market as at December 2001 made up of 12 domestic

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<sup>19</sup> The assessment took place in April 2002 as part of the IMF-World Bank Financial Sector Assessment Program (FSAP), and was prepared by Craig Thorburn, Senior Financial Sector Specialist, Financial Sector Vice Presidency of the World Bank.



companies, 8 foreign companies and 2 joint ventures. The sector has been improving in its performance after a severe setback in 1997. Improved investment performance and a focus on productivity improvement, both in administrative operations and in distribution, have contributed. Companies are, however, still conscious of the need for further improvement including the need to prepare for the introduction of bancassurance.

### **C. General Preconditions for Effective Insurance Supervision**

110. **In Korea, the supervision of insurance falls under the FSC and the FSS.** The principal legislation for the supervision of insurance is the *Insurance Business Act*. The legal structure in Korea operates effectively and the supervisor is able to make use of the general corporate laws and accounting standards.

111. **Both the accounting and actuarial professions exist in Korea.** The accounting and audit profession is more developed than the actuarial profession, where membership is small and technical capacity is still developing. As a result, the KIDI plays a role in carrying out extensive research projects which would otherwise fall to the actuarial profession. There is scope for the actuarial profession to make greater use of more sophisticated financial techniques, and they should be encouraged to do so. In addition, the reputational standing of the actuarial profession could be enhanced through greater use of actuarial approaches and advice by companies.

### **D. Main Findings**

112. **The Korean authorities have made considerable strides in the development of their regulatory and supervisory structure since the 1997 crisis.** A high level of observance is achieved in the regulatory regime, reinforced by active supervision and enforcement on the part of the FSS and FSC.

113. **Organization of an Insurance Supervisor.** The insurance supervisory function is organized under the FSS and the FSC. This structure is adequately and flexibly resourced, operates clear lines of reporting and day to day decision making, and has established confidentiality and ethical requirements.

114. **The operation of MOFE and the Regulatory Reform Committee in interpreting and reviewing decrees, regulations, and rules has the potential to reduce the operational independence of the FSC and the FSS,** by clouding its autonomy and the ultimate responsibility for supervision and regulation. While it is appropriate to have some government body act as the ultimate reviewer of the regulatory and rule-making process, care is needed to ensure that any such review does not impinge on the operational independence of the FSC and the FSS.

115. **In line with international best practice, consideration should be given to providing legal protection for the FSC/SFC/FSS and their staffs against lawsuits when carrying out their duties in good faith and without negligence.**

116. **Licensing and Changes in Control.** The FSS and FSC operate a sound licensing regime which addresses all the IAIS criteria. The 'fit and proper' tests are formally applied to directors but could be more formally applied to senior management, and the inclusion of a

5-year ban could be altered to permit lifetime bans when relevant. Consideration could be given to removing the time limit for approval of applications. A regime for advice of change of control is in place but the requirement for approval is not in place but being given active consideration.

117. ***Corporate Governance and Internal Controls.*** With respect to corporate governance, the requirements for audit committees are relatively new and, whilst in place, have not been through a full cycle to ensure that the desired results are being achieved. Initial experience, particularly with respect to external directors, has indicated companies will need some time to gain experience in working with these requirements. Consideration may also be given to requiring separation of roles between chairmen, chief executives, and actuaries with official responsibilities. In addition, it may be useful to consider a mechanism for filling casual vacancies of non executive directors so as to ensure that the relevant effect and intention of the regulations were able to be maintained continuously rather than having to await a general meeting to be convened.

118. ***Prudential Rules.*** A comprehensive set of prudential rules has been developed since the crisis. Asset rules provide for asset management, financial derivatives, the mixture and diversification of assets, credit risk limits, and the treatment of particular types of assets. Assets are generally valued at market value for the purpose of financial reports. Pledging of assets is not permitted. The supervisor assesses the adequacy of liabilities and technical provisioning through off site analysis and on site inspections and assesses reinsurance recoveries being claimed against gross provisions. Particular attention is also given to catastrophe type provisions. KIDI prepares technical information to assist companies, particularly for incurred but not reported provisions for non life insurance companies. The provisioning for liabilities in Korea is consistent with a market value based environment and, therefore, the value of the assets on balance sheets.

119. **The legislation and regulations on the supervision of insurance business imposes an EU modeled solvency regime.** With respect to the non life insurance sector, higher parameters have been adopted than applies in the EU, which is appropriate given the other financial and institutional aspects in Korea. With respect to the life insurance sector, the parameters adopted are the same as applies in the EU directives and are being phased in over a period. Solvency is monitored actively and control levels are identified. There is no specific attention under the solvency regime to the question of double gearing in groups, but there are cases in practice where this situation arises.

120. **Requirements with respect to derivatives and reinsurance show a high level of observance** of both the essential and additional criteria.

121. ***Monitoring, Inspection, and Sanctions.*** Insurance distributors are required to be authorized and be fit and proper. The fair dealing with customers is elaborated extensively with regard to the taking out of contracts, point of sale disclosure and illustration, and anti-twisting rules. The supervisor encourages companies to establish customer complaint handling procedures and, through an office within the FSS (the Customer Protection Center), also deals with and resolves customer complaints.

122. **Financial reporting to the FSS is satisfactory and all information is systematically analyzed off-site and subject to verification as part of the on-site inspection processes.** The legal basis for on-site inspections is set out in the law, including an obligation to carry out such inspections and request and obtain information. Inspections are conducted on a full scale basis as well as on specific matters.

123. **The FSS and FSC have the power to issue fines, limit business activity, force dealing with assets, and require the transfer of assets and liabilities to others or impose conservatorship.** A range of sanctions are available; licenses can be denied or revoked; and Boards of directors or management can be dismissed and replaced. There is a regime of prompt corrective action requirements in place.

124. **Cross-Border Operations, Supervisory Coordination and Cooperation, and Confidentiality.** It is permissible for overseas companies to operate through distribution in Korea with only limited requirements. As such the local authorities are reliant on the quality of the home supervisor. Consultation with home supervisors is practiced. The exchange of information with anti money laundering authorities is in its infancy and is developing. The *Act on the Establishment of the Financial Supervisory Organizations* includes a broad confidentiality clause that covers the essential criteria. There are, however, no specific exclusions or permissions included that address the exchange of information with other supervisory or legal authorities.

Table 2. Recommended Action Plan to Improve Observance of IAIS Insurance Core Principles

Reference Principle	Recommended Action
Organization of an Insurance Supervisor i.e., CP 1	<ul style="list-style-type: none"> <li>• Give supervisors legal protection for actions performed while discharging their duties in good faith, and legal protection against the costs of defending their actions while discharging their duties</li> <li>• The assessment of officers should be included as part of the supervisory processes.</li> </ul>
Licensing and Changes in Control i.e., CPs 2-3	<ul style="list-style-type: none"> <li>• Time based restrictions on licensing approvals should be abolished.</li> <li>• Fit and proper tests, currently applied formally to board members and informally to key senior management appointments should be applied formally to both.</li> <li>• The five year ban on industry participation should be changed to an indefinite one, particularly with respect to offences under the Act.</li> <li>• Proposals under consideration to achieve full observance of principle 3 are to be encouraged.</li> </ul>
Corporate Governance and Internal Controls i.e., CPs 4-5	<ul style="list-style-type: none"> <li>• Introduce a requirement for separation of roles between chairmen, chief executives, and actuaries with official responsibilities.</li> <li>• Introduce a mechanism for filling casual vacancies of non executive directors to ensure continuous implementation of regulations between general meetings.</li> </ul>

Reference Principle	Recommended Action
Prudential Rules i.e., CPs 6–10	<ul style="list-style-type: none"> <li>• The capital adequacy requirements need to be further enhanced, and double counting of capital needs to be prohibited.</li> <li>• Address capital levels through regulatory change and sanction but also through administrative incentives such as more favorable administrative treatment.</li> </ul>
Monitoring, Inspection, and Sanctions i.e., CPs 12–14	<ul style="list-style-type: none"> <li>• The ability of the supervisor, through formal powers, to inspect outsourced service providers could usefully be clarified through indirect or direct means.</li> </ul>
Cross-Border Operations, Supervisory Coordination and Cooperation, and Confidentiality i.e., CPs 15–17	<ul style="list-style-type: none"> <li>• Restrict the ability of companies to write business in Korea from other jurisdictions without limitation, so that the power to intervene in unsatisfactory situations can be provided.</li> </ul>

### E. Authorities' Response

125. As a way to ensure soundness of the insurance sector and enhance the transparency in the insurance market, the FSC/FSS has incorporated much of the IAIS core principles into the insurance regulations and has been enforcing them. In October 2002, the FSC/FSS adopted the consolidated solvency margin rule and has been taking other steps as part of our broad efforts to ensure prudential regulation of the domestic insurance industry. The FSC/FSS is also looking into ways to seek greater accountability from the officers of insurance companies.

126. In response to the recommended actions in Table 2, the assessment of officers is included in the revised Insurance law, which is currently pending at the National Assembly. Abolishing time-based restrictions on licensing approvals along with banning industry participation indefinitely will be given careful review taking into account relevant laws and circumstances.

### III. SUMMARY ASSESSMENT OF OBSERVANCE OF THE IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

127. This assessment of Korea's observance of the *IOSCO Objectives and Principles of Securities Regulation*<sup>20</sup> is based upon interviews with the Financial Supervisory Commission (FSC), the Securities and Futures Commission (SFC), and the Financial Supervisory Service (FSS), as well as discussions with Korean governmental officials, representatives of securities self-regulatory organizations (SROs) and members of the Korean securities industry. These interviews were supplemented with a self-assessment prepared by the FSC and additional reference materials, including copies of applicant laws, decrees, reports, and regulations. The FSC/SFC/FSS cooperated fully with the assessment.

<sup>20</sup> The assessment was performed by Mr. Jonathan Katz of the U.S. Securities and Exchange Commission from April 12–23, 2002, as one component of the Financial Sector Assessment Program (FSAP) of the International Monetary Fund (IMF) and the World Bank. Mr. Katz's views should not be considered the official position of the U.S. SEC.

## A. General

128. **There are two main markets for equities in Korea: the Korean Stock Exchange (KSE), and the KOSDAQ. At the end of 2001, 689 companies were listed on the KSE,** with a total market capitalization of W 255 trillion and a daily trading volume of approximately 610 million shares, with 66 percent of trading from on-line customers. Foreign investment in KSE companies is more than 36 percent. The KOSDAQ market has 721 listed companies with a market capitalization of W 52 trillion and daily trading volume of 367 million shares, predominantly short term on-line trading by individual (domestic) investors. In addition to these two markets, there is the the KOSDAQ OTC Bulletin Board system to enable trading in very small companies; the Korean Futures Exchange (KOFEX), a independent SRO; and Korea ECN Securities, a communications network that provides after hours trading in 200 KSE listed companies and 50 KOSDAQ listed companies. Korean markets function through direct interaction of orders. There are no market-makers or specialists acting as intermediaries. This may be a contributing factor to the high volatility in the Korean securities markets.

129. **There are 60 securities companies licensed by the FSC to operate in Korea, including 17 foreign companies, with 52 of these companies being members of the KSE.** The Korean securities industry is heavily concentrated, with the largest brokerage company controlling 14 percent of the market; its affiliated investment trust company and insurance company are also dominant. As of December, 2000 there were 79 investment advisory companies registered with the FSC. Banks and insurance companies, upon registration with the FSC, may only engage in underwriting and dealing in government bonds.

130. **The bond market in Korea is small. Government bonds totaled W 296 trillion in value (year 2000) and corporate W 133 trillion (2000).** While over 80 percent of debt is listed on the KSE, over 95 percent of trading occurs in the over the counter market, dominated by a small number of specialized dealers. The secondary market for corporate debt is also very thin. The OTC market in debt is heavily concentrated in five securities companies. There is little transparency, primarily because of a lack of active trading (prices are published daily based on valuation by the KSDA) and limited liquidity. Because of the tradition of holding debt to maturity, price discovery is difficult, as is locating contra parties. Although the KSE has just begun trading in repos, the market is restricted. ITC's are only permitted to engage in repos, not reverse repos.

131. **Private pension plans are uncommon and have limited assets to invest in equities. Insurance companies invest only a small proportion of their assets in equities.** Collective investment schemes and investment trusts are relatively small players in the Korean market, with the bulk of funds under management invested in government debt. There are two types of investment trust products offered in Korea, investment trusts (ITC) and investment companies (ITMC). The ITC's are contractual agreements and account for approximately 96 percent of all assets controlled by collective investment schemes. The limited effective life of most ITC's and ITMC's is a significant factor in the investment strategy for investors and, in turn, for the funds. Following the 1997 financial crisis, most Korean investors consider ITC's and ITMC's to be short-term investments. Under Korean law, the standard trust agreements impose a redemption penalty on investors who withdraw any invested funds from an open-ended IT within three months or six months for a closed-

end fund. The remaining 50 percent may not be withdrawn for another three months. There is a tendency for Korean investors to regard this period as the maturity date of the fund. Because of the volatility of the Korean market (among the highest in the world), most Korean investors immediately withdraw funds as soon as possible. The result is an institutional investment sector that is focused on the short-term and a contributor to volatility rather than stability.

## Oversight

132. **The FSC was created by the *Act on Establishment of Financial Supervisory Organizations* in 1998 to oversee regulation of Korean financial institutions and markets.** It is a statutorily independent agency, under the general authority of the President, responsible for coordinating the activities of and setting policy for the SFC and FSS. It has a small staff of approximately 65, supplemented with staff on loan from the FSS. The FSC is responsible for issuing and revoking licenses of financial institutions. The SFC was created under the *Act* with specific responsibility for investigating market abuses and for accounting and auditing standards. It, too, is a governmental entity with a small staff. The FSS, headed by a Governor who is concurrently the Chairman of the FSC, is the principal operational financial system regulator. Unlike the FSC and SFC, it is technically not a government agency and its budget is funded through annual fees imposed upon regulated entities. As such, it is not bound by Korean government civil service standards and salaries. The FSS has a staff of nearly 1500. The FSS has the authority to examine and inspect the operations of all Korean financial institutions. It may compel testimony and the production of documents from persons and entities subject to its regulation and may recommend to the FSC disciplinary action against financial institutions and associated persons.

133. **The Korean Ministry of Finance and Economy (MOFE) is the principal governmental institution charged with management of the Korean fiscal system and economy.** Until the 1998 reorganization, it was the agency responsible for regulation of banks and non-bank financial institutions. MOFE continues to have primary responsibility for drafting legislation and submitting it to Parliament and for official interpretation of Korean financial laws and related Presidential Decrees. The Vice-Minister of MOFE is an *ex officio* member of the FSC.

## B. Main Findings

134. ***Principles relating to the regulator.*** When viewed as a consolidated regulator, the FSC/FSS/SFC has sufficient authority to perform its regulatory duties. However, the trifurcated structure appears cumbersome and has the potential to impinge on regulatory effectiveness. While the FSC appears to make a concerted effort to solicit industry input into its policy deliberations, adoption of a formal public notice and comment procedure for proposed regulatory actions would enhance its ability to develop high-quality, cost-effective regulatory policies. In addition to enabling it to obtain the broadest possible range of public opinion, it would dispel any perception that some entities or components of the financial industry have an inordinate influence in the development of policy. A second concern is the overlap in interpretive responsibilities between the FSC/FSS and the MOFE. While the FSC/FSS has the authority to interpret its rules, the MOFE has the authority to interpret the law. This situation has the potential to reduce the operational independence of the FSC and

the FSS, by clouding its autonomy and the ultimate responsibility for supervision and regulation. While it is appropriate to have some government body act as the ultimate reviewer of the regulatory and rule-making process, care is needed to ensure that any such review does not impinge on the operational independence of the FSC and the FSS.

135. ***Principles of self-regulation.*** Korean SRO's have sufficient authority and appear to utilize it effectively in enforcing listing standards, but their exercise of authority is limited in some other key areas. They do not inspect or monitor member securities firms for compliance with capital adequacy standards (monthly reports to FSS are jointly filed with the appropriate SRO) or other regulatory requirements. Also, SRO disciplinary programs are limited in size and scope.

136. ***Principles for the enforcement of securities regulation.*** The FSC/SFC/FSS combination has sufficient comprehensive regulatory authority, and recent actions suggest a commitment to the effective use of this authority. While the SFC has statutory authority to oversee market misconduct, it relies upon FSS staff to perform much of the function. It may be useful to clarify the respective responsibilities of the two organizations.

137. ***Principles for cooperation in regulation.*** Because of the substantial infusion of foreign capital into Korean securities markets in recent years, it is highly likely that the FSC/SFC/FSS may have to investigate activities on the Korean markets that involve conduct by foreign investors. This will likely require the assistance of foreign regulators. However, foreign regulators as a general matter may not provide such assistance unless there is a memorandum of assistance that provides for reciprocity. Provisions of the *Real Name Transactions Act* have the potential to prevent an unimpeded exchange of information with foreign supervisors. Thus, the inability of the FSC to reciprocate may ultimately impede its ability to regulate its own markets effectively.

138. ***Principles for issuers.*** Korea has made a concerted effort to improve the quality of corporate disclosure through improved requirements, combined with an initiative to improve corporate governance and the quality of Korean accounting standards. Korean accounting standards are now approaching International Accounting Standards (IAS), and auditing standards are now fully consistent with international standards. The regulators have also strengthened enforcement by imposing sanctions on accountants for violations of standards or rules. Effective implementation of these standards and the quality of auditing, accounting, and financial and non-financial disclosure needs to be further improved in order to be consistent with practices in other advanced industrial countries. A major impediment to complete implementation of Korean GAAP and GAAS is a shortage of properly trained accountants, auditors and corporate financial officers. A second impediment may be the historically low audit fee paid by Korean companies, estimated to be roughly 20–25 percent of the comparable audit fees paid in Japan and the United States.

139. ***Principles for collective investment schemes.*** There is an established system for regulation of collective investment schemes, which do not play a major role in the Korean financial system. The requirement that the management company invest a minimum of W 100 million on in the start up of an ITMC may be a contributing factor in the limited use of ITMCs, given that they have a typical life span of less than two years.

140. **Principles for market intermediaries.** Korea has a comprehensive regulatory structure for brokerage firms. Its system for overseeing capital adequacy of firms should be carefully monitored to ensure that it can identify firms with capital deficiencies in a timely manner. For example, the FSS could impose a more frequent computation and reporting requirement. Close oversight of firm capital adequacy is particularly important given the volatility in the Korean market and the generally low capital levels of all but the largest firms. The requirement that underwriters act as market stabilizer for 30 days after an offering of securities may also create risk exposure as well as depressing the offering price, as it creates a contingent liability for underwriters for the entire offering.

141. **Principles for the secondary market.** Korea's regulatory structure provides all necessary authority for adequate regulatory oversight. In fact, it may not be necessary for Korean regulators to actively involve themselves in detailed decision making on market products, and consideration could be given to granting Korean markets greater latitude in making such business decisions. Conversely, it may be appropriate for the FSS to increase its direct surveillance of the markets, given the limited amount of direct enforcement performed by the SRO's.

Table 3. Recommended Action Plan to Improve Observance of the IOSCO Objectives and Principles of Securities Regulation.

Reference practice	Recommended action
Principles relating to the regulator, CPs 1-5)	<ul style="list-style-type: none"> <li>Strengthen the operational independence of the FSC/FSS by allowing laws in the financial sector to be implemented by regulation. The MOFE should refrain from issuing its own interpretations of those regulations. Undertake measures to ensure that the operation of MOFE and the RRC in interpreting and reviewing decrees, regulations, and rules do not hinder the operational independence of the FSC/FSS.</li> <li>Amend relevant statutes to give FSC/SFC/FSS staff protection for actions performed while discharging their supervisory duties in good faith.</li> <li>Adopt a formal public notice and comment procedure for proposed regulatory actions.</li> </ul>
Principles of self-regulation (CPs 6-7)	<ul style="list-style-type: none"> <li>Recent initiatives to promote enhanced SRO regulatory responsibilities, including an on-site inspection program of firms, should be continued.</li> </ul>
Principles for the enforcement of securities regulation (CPs 8-10)	<ul style="list-style-type: none"> <li>Careful consideration should be given to how the distribution of responsibilities between the SFC, FSS and MoFE affects overall effectiveness.</li> <li>SRO's should be encouraged to increase their enforcement and disciplinary programs.</li> </ul>
Principles for cooperation in regulation (CPs 11-13)	<ul style="list-style-type: none"> <li>Reexamine the existing interpretation of the <i>Real Names Act</i> and if necessary seek a statutory amendment to ensure an unimpeded exchange of information between supervisors.</li> </ul>
Principles for issuers (CPs 14-16)	<ul style="list-style-type: none"> <li>Assess the implementation of new accounting and auditing standards to ensure their application is consistent with international standards and best practice.</li> <li>Encourage the training and recruitment of qualified accountants, auditors, and attorneys.</li> </ul>
Principles for collective investment schemes (CPs 17-20)	<ul style="list-style-type: none"> <li>Examine the impact of existing regulatory policies on collective investment schemes to ensure they are not impeding the growth of the industry.</li> </ul>
Principles for market intermediaries (CPs 21-24)	<ul style="list-style-type: none"> <li>Require more frequent computation and reporting of capital adequacy.</li> <li>Assess the impact of recent regulations governing internal compliance functions.</li> </ul>
Principles for the secondary market (CPs 25-30)	<ul style="list-style-type: none"> <li>Regulations designed to manage market volatility should be reexamined to improve their effectiveness.</li> </ul>



Reference practice	Recommended action
	<ul style="list-style-type: none"><li data-bbox="760 247 1497 300">• A concerted effort should be made to improve transparency in the bond market.</li><li data-bbox="760 304 1497 352">• Examine restrictions on derivatives use and hedging strategies to see if they are reducing market depth and liquidity or increasing volatility.</li></ul>

### C. Authorities' Response

142. The FSC/FSS has been observing the international standards in most areas including capital adequacy and internal control. Especially, the FSC/FSS is reviewing the internal control standard on a regular basis to ensure that the compliance officer system and Internal Control System (ICS) take root. Both systems were initiated in 2000 and the FSC/FSS is evaluating the ICS of securities companies when performing on-site examinations.

## IV. SUMMARY ASSESSMENT OF OBSERVANCE OF THE CPSS CORE PRINCIPLES FOR SYSTEMICALLY IMPORTANT PAYMENT SYSTEMS<sup>21</sup>

### A. General

143. **The Korean payment system consists of a central high-value funds transfer system, the Bank of Korea Financial Wire Network (BOK-Wire), which is operated by the Bank of Korea (BOK), and several other paper-based and electronic systems operated by the Korea Financial Telecommunications and Clearings Institute (KFTC), a company owned by payment system participants, including the BOK.** BOK-Wire is a wholesale funds transfer system that accounts for around 70 percent of the total value of cleared payments in Korea. All BOK-Wire transactions are settled on a real-time gross settlement (RTGS) basis across participants' settlement accounts at the BOK. A minimum transaction value of W 1 billion for customer payments is enforced, but there is no limit on funds transfers between BOK-Wire participants. Any financial institution holding a settlement account at the BOK is eligible to participate in BOK-Wire. Currently, banks, including all foreign bank branches, and non-bank institutions such as securities companies and merchant banking corporations participate in the system. As at end-2001, there were 132 members of BOK-Wire, of which 65 were banks and 67 were non-bank financial institutions.

144. **The KFTC-operated systems include a variety of interbank electronic payment systems.** The KFTC also operates a check clearing system and a paper-based bank giro system. Each of the KFTC-operated systems settles on a multilateral net basis through BOK-Wire at designated times (currently 2:30 p.m. for checks and 11:30 a.m. for all other

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<sup>21</sup> The assessment was undertaken in October 2001 by a two-person team: Anne-Marie Gulde (IMF), and Greg Johnston (payment system expert, Reserve Bank of Australia). The assessment was based on: the BOK's response to a pre-mission questionnaire; a review of relevant laws, regulations, and policies; a variety of official BOK publications and documents provided on the BOK website; and discussions with the BOK, the Korea Financial Telecommunications and Clearings Institute (KFTC), the Korea Securities Depository (KSD), the Korea Stock Exchange (KSE), and payment system participants.

KFTC systems). BOK-Wire is also used to settle high-value cash transfers between participants, BOK loans and discounts to banks, Korean Government treasury payments and receipts, and the cash leg of some securities settlement transactions. These securities transactions relate to over-the-counter (OTC) trades in debt securities markets. At present, the BOK estimates that up to 40 percent of the total value of debt securities trades are settled on a delivery-versus-payment (DvP) basis via a link between BOK-Wire and the KSD.<sup>22</sup> Cash payments relating to the remaining 60 percent are made using other payment mechanisms, such as the Electronic Banking System and cashiers' checks (i.e., a check drawn by a bank on itself). These transactions are not settled on a DvP basis. It is possible that the existing market practice of settling debt securities trades on the day the trade occurred (i.e., T+0), which exceeds current international best practice, may be impeding BOK's attempts to encourage DvP settlement.

**145. The check clearing system is the second most important clearing system in Korea in terms of the value of transactions cleared, accounting for a little under 19 percent of the total value of cleared payments.** There are a number of reasons for this. First, promissory notes (which are cleared in this system) are actively used as a means of payment for commercial transactions. These instruments account for around 40 percent of the total value of items cleared in the check system. Second, cashiers' checks are widely used as a means of paying for larger-value commercial transactions between individuals (e.g., car and house purchases) and between companies. These instruments are also used as a substitute for higher-value currency notes. (The largest currency note on issue in Korea is the W 10,000 currency note, which is worth approximately \$8 dollars.) However, data provided by the BOK indicate that the substitution of cashiers' checks for higher-value currency notes has a significant influence on the volume, but not the value, of checks exchanged in the Korean payments system. Third, cash payments relating to the settlement of some OTC debt securities trades and exchange-traded equities transactions are made using cashiers' checks. This is less than optimal as the rules of the check system allow checks drawn on a failed bank to be unwound.

### **Oversight**

**146. The BOK is the public sector agency responsible for the oversight of the Korean payment system.** Under the *Bank of Korea Act*, the BOK has the authority to operate and manage payment systems for the purposes of implementing its monetary and credit policies. Since 1994, the BOK has operated BOK-Wire. The BOK performs other payments-related activities, including issuing currency and providing current accounts for the settlement of interbank obligations among financial intermediaries.

**147. In December 2001, the BOK's Monetary Policy Committee (MPC) passed a new regulation—the *Regulation on the Operation and Oversight of Payment Systems*—that, among other things, sets out BOK's oversight objectives and requires the Governor to submit an annual report to the MPC on the BOK's oversight activities.**

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<sup>22</sup> Settlement on a DvP basis ensures that the transfer of cash occurs if, and only if, the transfer of title to securities occurs, and vice versa.

## B. Main Findings

148. **BOK-Wire has a high degree of compliance with the Core Principles.** There is one issue, relating to the ability of the BOK to oversee private sector systems' compliance with the Core Principles that could be significantly improved.

149. *Central Bank Responsibilities in applying the CPs.* Under the current arrangements, the BOK is not explicitly responsible for ensuring that risks are controlled in private sector payment systems, nor does it have powers defined in legislation to intervene in circumstances where it believes that private-sector payments arrangements may compromise the stability of the Korean payment system. In these circumstances, the BOK's payment system policy objectives may not always be fully achieved, or achieved within an acceptable time frame. This is not optimal given the potential for poorly designed payment systems to quickly transmit financial shocks, such as the insolvency of a payment system participant, throughout the financial system.

150. **Emerging best practice around the world is for central banks to have an explicit legislative mandate for the stability, and sometimes also the efficiency of the payment system, and associated powers to ensure that this mandate can be carried out.** These powers often include the ability to require data, set risk control and other standards and issue directions to payment system operators. It is also common for the central bank to have to provide an annual report to the Government outlining key payment system issues and the actions it has taken to achieve its policy objectives.

151. *Efficiency and practicality of the system (CP VIII).* The BOK-Wire system provides a low cost and effective service to its participants. At present, there is no limit on the minimum value of interbank payments. However, Article 21 of the *Working Regulation on the Operation and Oversight of Payment Systems* requires that customer payments must have a value of at least one billion won.

152. **It is recommended that steps be taken to reduce the value of payments cleared through the check system.** To promote this objective, it is recommended that the minimum transaction value of W 1 billion for customer payments through BOK-Wire be lifted, provided there is sufficient excess processing capacity to cater for the likely increase in transaction volumes. In addition, the exchange of higher-value promissory notes through the check system should be discouraged; BOK-Wire payments could be used as an alternative means of transferring funds to the presenters of these notes.

153. Further steps should also be taken, in concert with the KSD and financial market regulatory authorities, to ensure that cash payments forming one side of a securities settlement transaction take place through a payments mechanism that complies with the Core Principles; that interbank obligations arising from these cash payments are settled via BOK-Wire; and that all securities settlements occur on a DvP basis.

Table 4. Recommended Action Plan to Improve Observance of CPSS Core Principles and Central Bank Responsibilities in Applying the CPs

Reference principle	Recommended action
Central Bank Responsibilities in applying the CPs	<ul style="list-style-type: none"> <li>• The BOK's payment system role and objectives should be explicitly set out in legislation, along with processes to ensure institutional accountability. The BOK's oversight role should, at a minimum, include a responsibility for ensuring the smooth operation of the Korean payment system. Serious consideration should also be given to giving the BOK a mandate to promote the efficiency of the Korean payment system.</li> <li>• Accompanying legislative powers should also be introduced to ensure that the BOK has the ability to carry out its mandate. These should include the ability to require relevant data from payment system participants, set technical and other standards (such as membership standards) relating to the exchange and settlement of payments, and issue directions to payment system participants that are not complying with its standards. These measures could be implemented via amendments to the <i>Bank of Korea Act</i>, or through separate legislation dealing with payment system oversight.</li> </ul>

**C. Authorities' response**

154. **The BOK was in broad agreement with the assessment.** With regard to having an explicit legislative mandate specifying the responsibilities and powers of the BOK for payment system operation and oversight, the BOK will strive to have these provisions inserted into the *BOK Act* at some future date when a review of the *Act* or other relevant legislation is undertaken.

155. **The BOK and the Korean Government have already introduced various arrangements for the substitution of promissory notes, such as Corporate Procurement Loans, Electronically-Processed Secured Receivables Loans, Corporate Procurement Cards, and Electronic Receivables System for Business-to-Business transactions.** The BOK will continue to support these arrangements for a further substitution of checks and bills, including promissory notes. Serious consideration will be given to implementing the recommended actions, in order to reduce the value of payments cleared through the check system.

## V. SUMMARY ASSESSMENT OF OBSERVANCE OF THE CODE OF GOOD PRACTICES ON TRANSPARENCY IN MONETARY AND FINANCIAL POLICIES

### A. Transparency of Monetary Policy<sup>23</sup>

#### General

156. The *Bank of Korea Act* defines the objectives and responsibilities of the Bank of Korea (BOK), and requires the BOK to set a price stability target each year in consultation with the Government, and to formulate and implement an operational plan to achieve this target. The BOK is required to publish monthly balance sheets and an annual balance sheet, as well as an annual report. The BOK is required to submit a report to the National Assembly at least once a year on the implementation of monetary and credit policies, and the Governor is required to appear before the National Assembly to discuss the report. The internal auditor of the BOK is required to submit a comprehensive audit report to the Government and to the MPC on an annual basis, and the BOK must be audited by the National Board of Audit and Inspection (the official government auditing body) each year.

#### Main findings

157. *Clarity of roles, responsibilities, and objectives of the central bank for monetary policy.* In general, the BOK practices a high degree of transparency in most aspects of its operations. There are a few areas where further steps could be taken to improve transparency, as discussed below. The BOK has a set of internal procedures in place that govern procurement, which are not publicly disclosed, but are provided to prospective bidders and are available to interested parties upon request.

158. *Open process for formulating and reporting monetary policy decisions.* While the *BOK Act* requires an annual target for inflation, in practice, the operating horizon of monetary policy is often outside the target period, because monetary policy decisions will have limited impact on inflation in the remainder of the year, but a potentially significant impact on inflation next year. The adoption of a medium-term target by the MPC partly compensates for this problem. This complexity in the inflation targets and the resulting potential for public misunderstanding is a consequence of the *BOK Act* rather than BOK practices, and the BOK is seeking to improve the Act in due course. The BOK consults with commercial banks and other financial institutions on a consistent basis, providing them with a broad description of the proposed changes. These consultations usually occur within one to three months prior to the enactment of the change.

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<sup>23</sup> The assessment was undertaken in October 2001 by a three-person team: Matthew T. Jones, Tomás J. T. Baliño, (both IMF), and Pedro Teixeira (European Central Bank).

159. **Public Availability of Information on Monetary Policy.** The statistical releases of the BOK meet almost all of the requirements of the IMF's Special Data Dissemination Standard (SDDS) for the coverage, periodicity, and timeliness of data and for dissemination of advance release calendars, with the exception of the international investment position. The BOK intends to publish international investment position data for 2002 by June 30, 2003. The balance sheets presented in the BOK's *Annual Report* are in summary form only, and do not provide a detailed picture of the balance sheet. The accounting rules followed by the BOK in preparing its balance sheets are not publicly disclosed.

160. **Accountability and assurances of integrity by the central bank.** The BOK also has its own internal administrative rules regarding organizational and personnel matters, accounting, and welfare issues. These internal administrative procedures are not published or available to the public. There are no general legal protections for BOK staff.

Table 5. Recommended Action Plan to Improve Observance of IMF's MFP Transparency Code Practices—Monetary Policy

Reference Practice	Recommended Action
I. Clarity of Roles, Responsibilities and Objectives of Central Banks for Monetary Policy	<ul style="list-style-type: none"> <li>• A clearer explanation of the principles and procedures governing BOK commercial transactions could enhance the quality of disclosure of the BOK's activities. This could include the disclosure of procurement procedures and guidelines.</li> </ul>
II. Open Process for Formulating and Reporting Monetary Policy Decisions	<ul style="list-style-type: none"> <li>• The BOK's inflation targeting framework, with an annual inflation target and a medium-term inflation target, could be made more transparent by modifying the BOK Act and accompanying regulations to allow for a longer time horizon for the inflation target.</li> <li>• The BOK could consider consulting with a wider range of potentially interested parties on technical changes to regulations. This could be achieved, for example, by posting the text of proposed changes in regulations on the website and inviting public comments within a specified time period, for all proposed changes.</li> </ul>
III. Public Availability of Information on Monetary Policy	<ul style="list-style-type: none"> <li>• The BOK could provide international investment position data on a more timely basis, in order to comply fully with the requirements of SDDS.</li> </ul>
IV. Accountability and Assurances of Integrity by the Central Bank	<ul style="list-style-type: none"> <li>• Internal administrative rules of the BOK that deal with substantive policy issues may warrant publication: for example, the internal rules of the MPC allow the MPC to not disclose all or part of the content of the minutes on the basis of financial stability considerations, or the accounting rules of the BOK that are relevant for assessing the auditing procedures of the BOK. Public disclosure of these types of regulations can help assure the public that the BOK has adequate procedures and processes in place to ensure the integrity of its operations.</li> </ul>

Reference Practice	Recommended Action
IV. Accountability and Assurances of Integrity by the Central Bank (continued)	<ul style="list-style-type: none"> <li>• Disclose of additional information on auditing policies and processes (including accounting rules) the BOK follows in preparing its financial statements could help to improve the public's understanding of the financial statements and operations of the BOK.</li> <li>• The BOK could provide additional information on the extent of legal protections and prescribed standards of conduct for the MPC and staff of the BOK, for example, in a separate dedicated document on staff accountability made available on its website.</li> </ul>

### Authorities' response

161. **The BOK was in broad agreement with the assessment, and intends to take appropriate measures to heighten transparency in monetary policy. Regarding the process for formulating monetary policy, the *BOK Act* requires the BOK to set an annual inflation target.** Although the medium-term target is not required by law, it has been established and operated since 2000. According to the BOK, the medium-term target is intended to compensate for the limitations of the annual target. Currently, the mid-point of the annual inflation target is within the range of the medium-term target. The BOK provides a detailed background explanation of the annual and medium-term inflation targets in its various publications, including the *Annual Report*, the *Monetary Policy Report*, and press releases.

162. **Regarding changes to regulations, the BOK consults with commercial banks and non-bank financial institutions in most cases, and reflects their suggestions and ideas when amending monetary policy related regulations.** In the opinion of the BOK, when major matters are to be amended, it follows reasonable procedures for gathering the opinion of the financial community. The BOK plans to publish the accounting rules, policies, and footnotes relating to financial statements from fiscal year 2003.

### B. Transparency of Payment System Oversight<sup>24</sup>

#### General

163. **The BOK is the public sector agency responsible for the oversight of the Korean payment system.** Under the *Bank of Korea Act*, the BOK has the authority to operate and manage payment systems for the purposes of implementing its monetary and credit policies. In December 2001, the BOK's Monetary Policy Committee (MPC) passed a new regulation—the *Regulation on the Operation and Oversight of Payment Systems*—that,

<sup>24</sup> The assessment was undertaken in October 2001 by a three-person team: Matthew T. Jones, Anne-Marie Gulde (both IMF), and Greg Johnston (payment system expert, Reserve Bank of Australia).

among other things, sets out BOK’s oversight objectives and requires the Governor to submit an annual report to the MPC on the BOK’s oversight activities.

**Main findings**

164. *Clarity of roles, responsibilities, and objectives of financial agencies.* The institutional framework for payment system oversight is largely defined in the *Bank of Korea Act* and the *Regulation on the Operation and Oversight of Payment Systems*. The *Regulation* sets out the BOK’s payment system objectives and reporting requirements. It also seeks to provide a legal basis for the BOK to require data and reports from payment system participants, conduct inspections, and impose sanctions or corrective measures on payment system operators or participants that violate its regulations or rules. However, this regulation is not underpinned by legislation.

165. *Accountability and assurance of integrity by payment systems oversight agencies.* The BOK has its own internal administrative rules regarding organizational and personnel matters, accounting, and welfare issues. These internal administrative procedures are not published or available to the public. The accounting rules of the BOK are also not published. They follow the general accounting rules in place for government agencies. There are no general legal protections for BOK staff, and no disclosure of this lack of protection.

Table 6. Recommended Action Plan to Improve Observance of IMF’s MFP Transparency Code Practices—Payment Systems Oversight

Reference practice	Recommended action
V. Clarity of roles, responsibilities and objectives of payment systems oversight agencies	<ul style="list-style-type: none"> <li>The BOK should be provided with a legislative mandate for overseeing the Korean payment system. The BOK’s policy objectives should be clearly stated in the legislation, along with associated powers to achieve these objectives and processes to ensure institutional accountability. These arrangements could be set out in the <i>Bank of Korea Act</i> or in separate legislation dealing with payment system oversight.</li> </ul>
VIII. Accountability and assurance of integrity by payment systems oversight agencies	<ul style="list-style-type: none"> <li>Internal administrative rules of the BOK that deal with substantive policy issues could be disclosed. These could include internal governance procedures for managing risks associated with its trading and other operations, policy development and approval procedures and the accounting rules and auditing procedures of the BOK. Public disclosure of these types of regulations can help assure the public that the BOK has adequate procedures and processes in place to ensure the integrity of its operations.</li> </ul>



## Authorities' response

166. **The BOK was in broad agreement with the assessment.** With regard to having an explicit legislative mandate specifying the responsibilities and powers of the BOK for payment system operation and oversight, the BOK will strive to have these provisions inserted into the *BOK Act* at some future date when a review of the *Act* or other relevant legislation is undertaken. The BOK plans to publish the accounting rules, policies, and footnotes relating to financial statements from fiscal year 2003. The BOK will also expand the public disclosure of internal governance procedures that are considered necessary to assure the public of the integrity of its operations.

### C. Transparency of Banking, Insurance, and Securities Supervision<sup>25</sup>

#### General

167. **The Act on the Establishment of Financial Supervisory Organizations (AEFSO)** establishes the Financial Supervisory Commission (FSC)/Securities and Futures Commission (SFC)/Financial Supervisory Service (FSS) as a unified regulator for Korean financial markets, covering banking, insurance, securities markets, and nonbank financial institutions. The Act states that the objective of the FSS is to examine and supervise financial institutions under the directions of the FSC or the SFC. The relationships between the key financial agencies (the FSC, the SFC, the FSS, the BOK, the KDIC, and the MOFE) are also defined in the *AEFSO*.

#### Main findings

168. **Clarity of roles, responsibilities, and objectives of financial agencies.** The broad objectives for the FSC and the FSS are clearly defined in the *AEFSO*. Procedures for appointment, terms of office, and any general criteria for removal of the heads and members of the governing bodies of financial agencies are defined in *AEFSO*. The objectives are elaborated in speeches, articles and public documents issued by the FSC and the FSS. The FSC and FSS submit to an annual audit and inspection by the National Assembly and receive National Assembly requests for information and testimony from officials. The *AEFSO* is available from the FSS in hard copy and on its website.

169. **For insurance, the FSS and the Korean Insurance Development Institute work closely together on aspects of product supervision although the KIDI is not a fully authorized self-regulatory organization.** The KIDI produces an annual report on its operations with respect to these and other aspects of its work.

170. **Open process for formulating and reporting of financial policies.** The regulatory framework governing the conduct of financial policies is outlined in the *AEFSO*, with operating procedures specified in the regulations issued by the FSS and made available in

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<sup>25</sup> The combined assessment was undertaken in April and October 2002 by a team consisting of Tomás J.T. Balifo, Matthew T. Jones, Greta Mitchell Casselle (all IMF); Larry Promisel, and Craig Thorburn (World Bank).

hardcopy and on the website. Policies, objectives, and changes to regulations are explained in a variety of publications available from the FSS in hard copy and on their website. For proposed substantive technical changes to the structure of financial regulations, industry consultation is conducted, although the FSS could consider consulting with a wider range of potentially interested parties by inviting public comments within a specified time period, for all proposed changes. The FSC discloses the existence of memoranda of understanding with foreign supervisory authorities in the weekly newsletters and on its website.

171. **Public availability of information on financial policies.** The FSS maintains an extensive public information service that publishes and disseminate press releases and reports on financial supervisory policies to the public. The FSS publishes an *Annual Report*, which provides a broad overview of developments in the industry; a *Weekly Newsletter*, which contains articles discussing broad trends in the industry; press releases about specific developments in the financial sector; and a *Monthly Financial Statistics Bulletin* with aggregate data on financial institutions. All of these publications are available in hard copy and on the extensive FSS website. Senior officials hold press conferences, deliver lectures, give interviews and attend public meetings of industry bodies, with the text of these public addresses generally made available on the FSC or FSS website.

172. **Accountability and assurances of integrity by financial agencies.** The FSC/FSS report to the National Assembly twice a year (at the beginning of the year and during the regular session of the National Assembly) and exchange views with members of the Assembly on the state of the financial system. The FSS is audited every year by the National Board of Audit and Inspection, an independent government agency. The FSS does not publish audited financial statements but they do follow the general accounting rules in place for government agencies. The FSS discloses a summary balance sheet and income statement in its *Annual Report*. It also has its own internal administrative rules regarding organizational and personnel matters (including rules governing conflicts of interest), accounting, and auditing arrangements. The full range of internal administrative procedures are not published or available to the public. There are no legal protections for officials and staff of government agencies. The Legal Affairs Office of the FSS defends lawsuits brought against the FSS and its staff pertaining to the official conduct of their duties.

Table 7. Recommended Action Plan to Improve Observance of IMF's MFP Transparency Code Practices—Banking, Insurance, and Securities Supervision

Reference practice	Recommended action
V. Clarity of roles, responsibilities and objectives of financial policies agencies	<ul style="list-style-type: none"> <li>Greater clarity and more disclosure of information on the role and operations of the KIDI and its relationship with the FSC/FSS would improve the transparency of this important self regulatory organization.</li> </ul>
VI. Open process for formulating and reporting of financial policies	<ul style="list-style-type: none"> <li>The FSS could consider consulting with a wider range of potentially interested parties on technical changes to regulations. This could be achieved, for example, by posting the text of proposed changes in regulations on its website and inviting public comments within a specified time period, for all proposed changes.</li> </ul>

Reference practice	Recommended action
VIII. Accountability and assurance of integrity by financial agencies	<ul style="list-style-type: none"> <li>• The FSS should publish audited financial statements, including more detailed balance sheets that provide the breakdown of expenses and sources of income to enhance the transparency of the FSS internal operations. In addition, disclosure of the FSC/FSS accounting rules and policies could help improve the public's understanding of the operations and financial statements of the FSC/SFC/FSS.</li> <li>• Provide information on the internal governance procedures, standards of conduct and conflict of interest rules in place for executives and staff, for example, in a separate dedicated document on staff accountability made available on the FSC/FSS website.</li> <li>• Provide information on the extent of legal protections of the executives and staff, for example, in a separate dedicated document on staff accountability made available on its website.</li> </ul>

**Authorities' response**

173. The FSC/FSS has been trying to establish the market-driven supervision system by encouraging the voluntary participation of all the interest parties in the market. In order to achieve this objective, the FSC/FSS has established the appraisal system to measure the effectiveness of supervision policy and the advisory committee for financial soundness. The fairness and efficiency of supervision policy have been enhanced by reflecting their feedback. In addition, the FSC/FSS will implement a new system to receive consultation papers from the market participants and scholars whenever the FSC/FSS try to set out new financial measures or strengthen the current ones.

174. The FSC, as a government agency, sets up its budget through legal procedures. Plus, at the end of each fiscal year, the FSC is obliged to submit financial statements to the National Audit Committee for audit and file the audit result to the National Assembly before the beginning of the following fiscal year. SFC operates on the FSC's budget since they are not separate administrative entities.

175. The FSS, in accordance with relevant regulations, requires and approval by the FSC. In addition, the FSS is already getting an annual audit by a private audit firm and discloses, on a regular basis, financial and budget information, including its financial statements on the web site.

176. Therefore, it should be noted that the FSC/SFC/FSS strictly observe accounting rules and the auditing and disclosure of the internal operations are being practiced in a transparent manner.

## D. Transparency of Deposit Insurance<sup>26</sup>

### General

177. The KDIC was created under the *Depositor Protection Act* (DPA) of 1995 with the objective of operating the deposit insurance system prescribed in the Act. The broad objectives, institutional framework, modalities of accountability, and procedures for appointment and removal of senior officials are defined in the DPA and in the *Public Fund Management Special Act* (PFMSA). Copies of the DPA and PFMSA are included in the *Annual Report*, which is available in hardcopy and on the website. The regulatory framework governing the operations of the KDIC is specified in the DPA and PFMSA and their associated enforcement decrees. Major policy changes are announced and explained via press releases at the conclusion of meetings of the Policy Committee, and in regular interviews and speeches by the President of the KDIC. The KDIC also describes its objectives, performance, and policy changes in its *Annual Report*. The KDIC provides extensive, detailed information on financial support provided to insured institutions on its website and in its *Annual Report*, disaggregated by type of financial institution, by type of financial support, by month, and by individual institution.

### Main findings

178. ***Public availability of information on financial policies.*** Senior officials of the KDIC appear in the media and give speeches and interviews. The transcripts of such interviews are disclosed in some instances on the KDIC website. A presumption in favor of disclosure of the text of public statements by senior agency officials would be helpful to ensure equal access to the statements of senior officials.

179. ***Accountability and assurances of integrity by financial agencies.*** The accounting rules of the KDIC are not published. The accounting principles and rules utilized by KDIC are basically the same as the Korean GAAP with minor discrepancies. Additional information on discrepancies between the KDIC's accounting rules and Korean GAAP accounting rules and policies would be helpful. A more detailed breakdown of operating expenses and more extensive use of accompanying notes in the financial statements would enhance the transparency of operations.

180. **In general, the KDIC does not provide legal protection for the executives and staff.** However, in respect of specific circumstances related to staff of KDIC assigned as trustees of bankruptcy estates or management supervisor of failed financial institutions, the KDIC does provide legal protection as they conduct relevant business under the guidance of the KDIC even though the business is conducted outside of KDIC. The internal regulations regarding KDIC staff, such as the code of conduct for KDIC employees are not publicly disclosed.

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<sup>26</sup> The assessment was undertaken in October 2001 and October 2002 by a four person team: Tomás J. T. Baliño, Matthew T. Jones, and Greta Mitchell Casselle (all IMF), and Pedro Teixeira (European Central Bank).

Table 8. Recommended Action Plan to Improve Observance of IMF's MFP Transparency Code Practices—Deposit Insurance

Reference practice	Recommended action
VII. Public availability of information on deposit insurance policies	<ul style="list-style-type: none"> <li>• A presumption in favor of disclosure of the text of public statements by senior agency officials would be helpful.</li> </ul>
VIII. Accountability and assurance of integrity by deposit insurance agencies	<ul style="list-style-type: none"> <li>• Public disclosure of information on internal governance procedures and auditing arrangements could help assure the public that the KDIC has adequate procedures and processes in place to ensure the integrity of its operations.</li> <li>• The KDIC could provide information on the standards of conduct and conflict of interest rules in place for executives and staff, for example, in a separate dedicated document on staff accountability made available on its website.</li> <li>• The KDIC could provide information on the extent of legal protection of the executives and staff, for example, in a separate dedicated document on staff accountability made available on its website.</li> </ul>

**Authorities' response**

181. **In terms of basic accounting rules or “Criteria for Account Settlement,” they have been disclosed in the Annual Reports since 2000.** As the governing accounting principles and rules utilized by KDIC are basically the same as the Korean GAAP with minor discrepancies, KDIC does not necessarily believe that any further disclosure is necessary for enhancement of public’s understanding of the KDIC accounting practices. In terms of internal governance procedures, the KDIC is considering limited disclosure of some internal governance procedure and auditing arrangements. Furthermore, KDIC views the two items as rather proprietary to each individual organization. In terms of standards of conduct for employees, the KDIC does have a “code of ethical conduct” and will consider posting it on its website. In terms of legal protections for staff, the KDIC is considering disclosure the extent of specific circumstances where legal protection is provided for staff of KDIC assigned as trustees of bankruptcy estates or management supervisory of failed institutions.

**VI. SUMMARY ASSESSMENT OF OBSERVANCE OF THE OECD PRINCIPLES OF CORPORATE GOVERNANCE**

182. **This assessment of the quality of corporate governance in Korea was performed as part of the joint IMF/World Bank Financial Sector Assessment Program (FSAP),** conducted during April 11–23 in Seoul.<sup>27</sup> The assessment was conducted by determining the

<sup>27</sup> Behdad Nowroozi from the East Asia and Pacific Region of the World Bank prepared the assessment, based on information drawn from the template completed by Professor Kon Sik Kim for the World Bank and technical discussion with the Financial Supervisory Commission (FSC), the Financial Supervisory Service (FSS), the Korea Stock Exchange (KSE), the Korea Securities Dealers Association (KSDA), the Korean Accounting Standards Board (KASB), the Korean Institute of Certified Public Accountants (KICPA), the Korea Securities Depository (KSD), and the Ministry of Finance and Economy (MOFE). The  
(continued)

levels of observance with the Organization for Economic Cooperation and Development (OECD) *Principles of Corporate Governance* (the “*OECD Principles*”). The assessment also identified areas where further development may be appropriate.

#### A. General

183. **For the purpose of the *OECD Principles*, corporate governance is “that structure of relationships and corresponding responsibilities among a core group consisting of shareholders, board members, and managers designed to best foster the competitive performance required to achieve the corporation’s primary objective.”**<sup>28</sup>

184. **Korea’s corporate ownership structure has been characterized by affiliation and cross-ownership among firms.** Families that run chaebol own far less than 50 percent of related companies, but they have had almost total control over the combined business group. Prior to 1998, ownership concentration combined with weak protection of outsider shareholders, an uncompetitive financial system, and opportunities for malfeasance and corruption by powerful insider shareholders, had led to corporate inefficiencies. In many instances, there had been little distinction between managers and owners. Collusion between chaebol and the government had further exacerbated failures of corporate governance. Large shareholders had been reluctant to install mechanisms that could erode their control and the benefits it brings.

185. **Since 1998, Korea has taken important steps to address corporate governance weaknesses.** The corporate governance framework has been strengthened significantly. Duties of directors on the boards of listed companies have been clarified. A Code of Best Practices for Corporate Governance has been issued. Minority shareholders rights have been strengthened through the reduction of thresholds for the exercise of certain rights. There has been good progress in upgrading accounting and auditing standards and practices and strengthening underlying institutions responsible for setting standards and ensuring compliance: accounting and auditing standards have been improved significantly and are now largely consistent with international standards, and the KASB, an independent standard-setting organization, has been established and is developing and issuing standards. The FSC/FSS have been established, and the role of the Korean Institute of Certified Public Accountants has been strengthened. While significant improvements have been made, efforts should continue to further improve accounting standards as well as accounting and auditing practices.

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assessment is also based on interviews conducted with private sector firms, accounting firms, investment bankers, rating agencies, and shareholder activists. Excellent cooperation was received from all agencies.

<sup>28</sup> A report to the OECD by the Business Sector Advisory Group on Corporate Governance, April 1998.

## B. Main Findings

186. **The reform agenda for corporate governance remains unfinished.** In order for Korea to deepen and strengthen its equity market, it needs to build on the excellent progress made to date and continue to improve corporate governance practices in a manner consistent with other OECD countries and international best practices. Going forward, Korea needs to deepen the progress made in improving financial transparency and shifting corporate culture in two directions: the separation of management from ownership, and the maximization of shareholder value rather than corporate size.

187. **While formal corporate governance rules may not now be substantially different from other OECD countries, corporate governance practices often fall short of the spirit, if not the letter, of the *OECD Principles*.** The challenge now lies in implementation and effective enforcement of legislative changes to improve the corporate culture and practices. Beyond the changes in legislation affecting corporate governance, the Government and the business community should take additional steps to change incentives and further promote transparency of business practices, particularly among chaebol groups; to strengthen competition policies, in order to expose chaebol and firms to stricter market discipline; to increase and enforce shareholder rights; and to improve disclosure and monitoring of related party transactions. While significant improvement has been made to improve accounting and auditing standards, efforts should continue to further improve accounting standards and improve accounting and auditing practices.

### **Rights of shareholders**

188. **Shareholder rights have been strengthened significantly to allow reduced levels of shareholdings for assertion of certain rights** such as demanding removal of directors and auditors, seeking injunctions against directors, initiating a derivative lawsuit, convening a general meeting of shareholders, and inspecting the account books of a company. Cumulative voting is now permitted, unless explicitly revoked in a company's articles of incorporation. While significant improvements have been made to increase minority shareholder rights (e.g., by lowering or eliminating threshold ownership requirements) and the ease with which shareholders exercise those rights, further improvements are required. These could include changing the incentives to make cumulative voting more appealing for large listed companies as a means of allowing minority shareholders a greater voice in the selection of directors (where a certain percentage of shareholders request it). Currently, more than 80 percent of listed firms have opted out of cumulative voting. Additionally, further steps should be taken to improve the process for nomination of independent directors by, for instance, requiring that at least two-thirds of members of outside nomination committees be independent directors.

### **Equitable treatment of shareholders**

189. **While derivative actions are allowed, these are costly and therefore have been limited so far to only a few cases.** The redress available to shareholders if their rights are violated remains limited. There is no cost-effective way for shareholders to seek redress.

There is an urgent need to introduce class action lawsuits by shareholders and investors against directors, managers, and auditors for breaches of duty and violations of the law.<sup>29</sup> The draft law submitted to the National Assembly to allow class action lawsuits should be enacted as soon as possible. Related party transactions are widespread in Korea, but since they involve controlling shareholders, or more often affiliated persons, rather than directors, they are not covered by the Commercial Code. Further steps should be taken to ensure that directors, controlling shareholders and other related parties make full disclosure to the board on related party transactions. Additionally, the accounting standard concerning related party transactions need to be made fully consistent with international standards.

### **Role of stakeholders in corporate governance**

190. **The role of institutional investors, who play a key role in corporate governance in many OECD countries, is an area that should be further developed.** This could be achieved, for example, through pension system reform to encourage further capital market development. Further consideration should be given to how to better ensure the rights of stakeholders and their protection in the corporate governance framework.

### **Disclosure and Transparency**

191. **Large chaebol have been required to prepare combined financial statements since the year 2000.** However, the transparency of related party and conflict-of-interest transactions within the chaebol, particularly between unlisted subsidiaries and third parties that may not be at arms-length, remains a challenge. While combined financial statements for large chaebol attempt to capture accounting information, non-accounting information may not be easily available or reliable. While holding companies are allowed, only a few have been established. In order to improve transparency and disclosures of chaebol-affiliated operations, several measures could be considered, including changing the incentives for large chaebol to establish holding companies (e.g., through lower taxes), and a shortening of the period for preparation of combined financial statements after the close of a financial year.

192. **Listed companies are now required to produce quarterly reports.** Further efforts will be required to ensure that listed companies report regularly to shareholders on the extent to which their corporate governance practices conform to the standards established by the Code of Best Practice for Corporate Governance.

### **Responsibilities of the Board**

193. **Large listed companies have been required to establish audit committees of the boards of directors.** However, the concept is new and audit committees are generally perceived to be neither effective nor adequately equipped to effectively discharge their oversight responsibilities. Efforts should continue to improve the effectiveness of audit committees, including measures to clarify and strengthen the role and function of audit committees consistent with international best practices; replace statutory auditors with audit

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<sup>29</sup> The draft class-action law has stalled in the National Assembly in 2002, but there has been an announcement by the new president that it will be reintroduced in 2003.



committees for smaller companies over time; and upgrade the skills and knowledge of audit committee members.

194. **Securities laws have been amended to require that at least 25 percent of boards of directors of listed companies be outside directors.** The statutory minimum is fifty percent (three outside directors at a minimum) for financial institutions and large listed companies. However, the concept of independent (outside) directors is new and still not well rooted in Korea. Directors may not know what is expected of them and how they should exercise their duties. There are efforts to establish an institute of directors to train directors on their duties, responsibilities, and accountabilities. There is an urgent need for such an organization and training of directors, and these efforts need to be expedited. Additional efforts could include measures to: expand the fiduciary duty of directors to shareholders and make it explicit under the law; further expand and clarify the right of directors to access all corporate information necessary to perform their duties; and limit liability of independent directors in cases in which they have acted in good faith.

Table 9. Recommended Action Plan to Improve Observance of OECD Principles of Corporate Governance

Reference Practice	Recommended Action
<b>I. Rights of Shareholders</b>	<ul style="list-style-type: none"> <li>• Make cumulative voting more appealing for large listed companies as a means of allowing taking additional steps to allow minority shareholders a greater voice in the selection of directors, including making cumulative voting more appealing for large listed companies.</li> <li>• Introduce, as soon as possible, class action law suits by shareholders and investors against directors, managers, and auditors for breach of duty and violation of the law.</li> <li>• Consider further steps to facilitate voting by foreign investors.</li> <li>• Consider allowing shareholders to cast vote electronically.</li> <li>• Improve the process for nomination of independent directors by, for instance, requiring that at least two-thirds of members of outside nomination committees be independent directors.</li> </ul>
<b>II. Equitable Treatment of Shareholders</b>	<ul style="list-style-type: none"> <li>• Introduce, as soon as possible, class action lawsuits by shareholders and investors against directors, managers, and auditors for breach of duty and violation of the law.</li> <li>• Consider allowing shareholders to cast votes electronically.</li> <li>• Require that directors, controlling shareholders, and other related parties make full disclosure to the board on related party transactions.</li> <li>• Consider further steps to strengthen rules governing self-dealing and insider trading by, for instance, excluding inside directors from decisions that involve potential conflict-of-interest or related party transactions.</li> </ul>
<b>III. Role of Stakeholders in Corporate Governance</b>	<ul style="list-style-type: none"> <li>• Strengthen stakeholders' rights and their protection in the corporate governance framework.</li> <li>• Promote participation of active institutional investors and pension funds in the equity market. Further strengthen institutional investor base through pension system reform to spur capital market development and improved governance.</li> </ul>

Reference Practice	Recommended Action
<p><b>IV. Disclosure and Transparency</b></p>	<ul style="list-style-type: none"> <li>• Further improve accounting standards and auditing practices in a manner consistent with international standards and practices.</li> <li>• Further improve quality of disclosure in annual and quarterly reports issued by listed companies, particularly in areas such as related party transactions, conflicts of interest on the part of directors and parties related to directors or managers, non-financial information, material foreseeable risk factors, and compensation of individual directors.</li> <li>• Consider requiring large listed companies to include in their annual reports an assertion on internal controls and their compliance with applicable laws and regulations; such an assertion should be certified by external auditors.</li> <li>• Change the incentives for large chaebol to establish holding companies, and shorten the period for preparation of combined financial statements after the close of a financial year.</li> </ul>
<p><b>V. Responsibilities of the Board</b></p>	<ul style="list-style-type: none"> <li>• Continue to improve effectiveness of audit committee, including measures to clarify and strengthen the role and function of audit committees.</li> <li>• Replace statutory auditors with audit committees for smaller companies over time, and upgrade the skills and knowledge of such committee members.</li> <li>• Further strengthen the roles and responsibilities of directors, including expanding the fiduciary duty of directors and making it explicit under the law and limiting liability of independent directors in cases in which they have acted in good faith.</li> <li>• Establish an institute of directors to offer directors' certification program for training of directors, particularly independent directors.</li> <li>• Further expand and clarify the right of directors to access all corporate information necessary to perform their duties.</li> <li>• Further clarify what constitutes independence and conflicts-of-interest for individual directors.</li> </ul>

### C. Authorities' response

195. The Korean government will make sure that the reform of corporate governance initiated in the late 1990s is effectively implemented. At the same time, the government will evaluate the performance of the past reform. Furthermore, additional measures will be taken to improve corporate governance if found necessary as a result of evaluation.

196. The government has expressed its strong will to adopt class-action suits, and even the new administration has chosen this matter as one of its top policy issues to pursue once the official term kicks off; however, because of strong resistance coming from the corporate sector, the bill is pending to the National Assembly.

197. Prior to the enactment of new or revised supervisory regulations, a public hearing is held when needed. Besides, new regulations are being thoroughly reviewed through sufficient review procedures by the public, e.g., Prior Written Notice of Regulation Changes.

## VII. SUMMARY ASSESSMENT OF OBSERVANCE OF THE DRAFT METHODOLOGY FOR ASSESSING LEGAL, INSTITUTIONAL AND SUPERVISORY ASPECTS OF ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM (AML/CFT)<sup>30</sup>

### A. Overview of AML/CFT Measures

198. **Korea has made recent strides in establishing an AML/CFT framework.** In November 2001, the *Financial Transaction Reporting Act* (FTRA) and the *Proceeds of Crime Act* (POCA) came into effect. The FTRA established the Korea Financial Intelligence Unit (KoFIU) and instituted a system of suspicious transaction reporting by financial institutions, including banks, securities firms, insurance firms and moneychangers. The POCA criminalized money laundering on the basis of a broad category of predicate crimes. There is a broad range of legal provisions for confiscation of assets associated with money laundering and terrorist financing.

### B. Legal and Institutional Setting

199. **The KoFIU is at the center of Korea's AML/CFT institutional framework.** Although the KoFIU is established within Ministry of Finance and Economy (MOFE), the FTRA provides that the KoFIU shall independently perform its authorized duties and that its staff shall not work outside of the KoFIU. The KoFIU has around 60 staff members drawn from MOFE, the Financial Supervisory Commission (FSC), the Financial Supervisory Service (FSS), the Public Prosecutors Office and other agencies. Establishment within MOFE formally means that the KoFIU's annual budget is allocated by the Ministry of Planning and Budget within the total budget of MOFE. However, the mission understands that MOFE is not entitled to draw on the specific budgetary allocation made to the KoFIU. The FTRA provides that the KoFIU shall report annually to the National Assembly. Although there is no legal provision for the KoFIU to report to MOFE, the informal influence of MOFE on the KoFIU operations cannot be ruled out.

200. **Korea has a unified financial sector regulatory and supervisory system in which the FSC and FSS oversee the banking, securities and insurance sectors.** However, the risk in the Korean AML/CFT institutional structure is that the KoFIU obtains undue prominence to the detriment of the role of the financial institutions and the regulatory/supervisory agencies.

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<sup>30</sup> This assessment was prepared on the basis of the standards and criteria described in the April 2, 2002 draft International Monetary Fund and World Bank Methodology for Assessing Legal, Institutional and Supervisory Aspects of Anti-Money Laundering and Combating the Financing of Terrorism. The assessment took place in April and October 2002 as part of the IMF-World Bank Financial Sector Assessment Program (FSAP), and was conducted by Mr. Thomas Laryea (April mission) and Mr. Stuart Yikona (October mission), both from the Legal Department of the IMF.

### C. Main Findings

201. **The FTRA specifically charges the KoFIU with the tasks of: (i) gathering, analyzing, and providing information on Suspicious Transaction Reports (STRs) and foreign exchange transaction reports; (ii) conducting the supervision and inspection of financial institutions' practices on STRs and adherence to internal AML guidelines and training requirements; and (iii) cooperating with foreign financial intelligence units.** The KoFIU has delegated the supervision and inspection of financial institutions' practices on STRs and internal AML guidelines to the respective supervisory agencies including the FSC/FSS with respect to banks, securities and insurance firms and to the BOK with respect to money changers.

202. **One of the core functions of the KoFIU is the operation of a computerized database to analyze information obtained through STRs and other sources.** The computer database became operational in September 2002, although it is too early to assess its impact. Additionally, the strategic analysis system of suspicious transactions became operational in November 2002. The FTRA authorizes the KoFIU to provide STRs with the KoFIU's own supporting analysis to "law enforcement agencies" for further investigation and action. The FTRA defines law enforcement agencies to include the Public Prosecutors Office, the National Police Agency, and the FSC.

203. **The KoFIU is also charged with the responsibility of promoting cooperation and exchange of information between Korea and overseas agencies in order to prevent money laundering.** In this regard, the KoFIU on June 5, 2002 joined the Egmont Group, established to foster international cooperation among financial intelligence units. The KoFIU has also entered into a memorandum for understanding with its counterpart in Belgium and is considering other international cooperative agreements. Furthermore, in August 2002, Korea engaged in an on-site examination by the Asia Pacific Group of the money laundering framework including financing of terrorism, indicating Korea's willingness to engage in international dialogue to enhance its AML/CFT regime.

204. **Although much progress has been made within the last year, the Korean AML/CFT system is still in its infancy. It is notable that STRs have been the main focus.** Under the FTRA, STRs are submitted by financial institutions only to the KoFIU, which then conducts analysis and investigation that may lead to referral of the matter to a "law enforcement agency" (in principle, including a regulatory agency). The current practice of the KoFIU is to analyze STRs from the perspective of advancing criminal prosecutions, leading the KoFIU to provide STRs with supporting analyses to the Public Prosecutors Office and the National Police Agency. The system does not take full advantage of the multifaceted nature of STRs in supervising the soundness of financial institutions (thereby bolstering the defenses against use of the financial institution in AML/CFT practices) in addition to being a tool for the *ex post* detection of money laundering and terrorist financing transactions.

205. **Under the FTRA, there is a monetary threshold on suspicious transaction reports of W 50 million/\$10,000.** The law does provide that related transactions should be combined for meeting the threshold and that the financial institutions *may* file STRs where the transaction value does not reach W 50 million /\$10,000. However, the threshold

inevitably acts as an inappropriate benchmark for the conduct of illegal/money laundering transactions and for their reporting.

206. **In contrast to the focus on STRs, the rules on customer due diligence, integrity standards of participants in financial institutions and general record keeping requirements have not been systematically integrated into AML/CFT system.** Where the appropriate rules and formal guidelines in the AML/CFT system have been put in place, there are still questions as to whether the operational practices are in line with the formal rules. The enhancement in supervision by the FSS of AML/CFT practices of financial institutions in mid-2002, with support from the KoFIU, should help to close the gap between the written regulations and industry practice. The limitation that the *Real Name Financial Transaction and Guarantee of Security Act (Real Names Act)* imposes on financial institutions' disclosure of customer information to third parties risks compromising the identification and investigation of money laundering and financing of terrorism incidents and impedes international cooperation.

207. **CFT has not received requisite attention in the Korean AML/CFT system.** CFT is obliquely addressed by provisions in the *Punishment of Violence Act, 1962* (as amended) and the *National Security Act, 1987* (as amended). Furthermore, the POCA incorporates CFT within the scope of predicate crimes. However, it is notable that relatively little regard has been given to CFT issues in the supervisory and industry guidelines associated with the recent legal reforms. The absence of ratification and implementation by Korea of the *International Convention for the Suppression of the Financing of Terrorism* (Terrorism Convention), which Korea has signed, contributes to the deficiencies in the incorporation of CFT in the AML/CFT system. The Korean authorities are currently preparing legislation for the implementation of the Terrorism Convention.

Table 10. Recommended Action Plan to Improve Observance of the Draft AML/CFT Guidelines

Reference Principle	Recommended Action
<b>LEGAL AND INSTITUTIONAL ARRANGEMENTS</b>	
Customer due diligence	<ul style="list-style-type: none"> <li>• Elaborate <i>Real Names Act</i> regulations to require an additional verification by financial service providers (FSPs) where doubts arise as to the original customer identification.</li> <li>• Extend customer identification provisions of the <i>Real Names Act</i> to branches or majority owned subsidiaries of Korean financial institutions.</li> <li>• Require that FSPs note originator information and related messages on funds transfers documentation through the payment chain.</li> </ul>
Record keeping	<ul style="list-style-type: none"> <li>• FSC/FSS should introduce a comprehensive requirement that FSPs maintain records on customer identity for at least five years following the termination of an account or business relationship (or longer if requested by an authorized government official) and that these documents be available for inspection by the FSS.</li> </ul>
Suspicious transactions reporting	<ul style="list-style-type: none"> <li>• Introduce regulations to require broad scrutiny by FSPs of complex or unusual transactions.</li> <li>• The ₩ 50 million/\$10,000 threshold for the mandatory filing of STRs should be eliminated and replaced with a criterion of suspicion (explicated through guidelines).</li> <li>• Regulations should require enhanced scrutiny of funds transfers that do not contain originator information.</li> <li>• STR guidelines should be thoroughly updated to address CFT issues. Furthermore the guidelines should be more nuanced in countering the traditional practice of FSPs of not</li> </ul>

	inquiring into their customers' business affairs.
AML/CFT internal controls	<ul style="list-style-type: none"> <li>The FTRA provisions on the STR Reporting Officer should be rationalized with the other provisions on internal controls and compliance officers in other laws and regulations.</li> </ul>
Sanctions	<ul style="list-style-type: none"> <li>Scrutiny of general record keeping practices should be enhanced in FSS inspections with regulatory sanctions for violation.</li> </ul>
Integrity standards	<ul style="list-style-type: none"> <li>Require that the fit-and-proper tests with respect to appropriate financial institutions, including banks, insurance firms and securities firms be extended to managers and significant shareholders, including for shell corporations that transact business, trust and company service providers and charitable organizations.</li> </ul>
Criminalization of money laundering and terrorism financing	<ul style="list-style-type: none"> <li>Implementation of the Terrorism Convention (through the proposed Anti-Terrorism Act) should be expedited</li> </ul>
Confiscation of proceeds of crime or assets	<ul style="list-style-type: none"> <li>Rules for confiscation of assets associated with terrorism financing should be explicitly provided for in the proposed Anti-Terrorism Act.</li> </ul>
Process for handling disclosure of financial information and intelligence	<ul style="list-style-type: none"> <li>Explicit restatement of (i) the legal protection of KoFIU employees and employees of regulatory/supervisory agencies for actions while carrying out their official duties; and (ii) the operational independence of the KoFIU from MOFE</li> </ul>
International cooperation in AML/CFT matters	<ul style="list-style-type: none"> <li>Remove uncertainty as to the legal ability of FSC/FSS to provide customer information to foreign counterparts through a reinterpretation or an amendment to the <i>Real Names Act</i>.</li> </ul>
<b>FOR AML/CFT CORE CRITERIA</b>	
Organizational and administrative arrangements	<ul style="list-style-type: none"> <li>KoFIU and industry guidelines should underline that the roles of the supervisory agencies and the FSPs are integral to the AML/CFT framework, should give clear direction to the FSC/FSS in supervising compliance with AML/CFT precepts, and should emphasize that the front-line responsibility is with FSPs for guarding against their use in money laundering and terrorist financing.</li> <li>The KoFIU should take a more proactive role in AML/CFT training and education within the supervisory agencies and FSPs.</li> </ul>
Customer identification and due diligence	<ul style="list-style-type: none"> <li>Customer identification and due diligence requirements should be more closely integrated into the AML/CFT framework. KoFIU and industry guidelines on AML/CFT should more fully explain the importance of customer identification and due diligence. Scrutiny of FSP's practices in customer identification and due diligence should be enhanced within FSS inspections.</li> </ul>
Monitoring and reporting suspicious transactions	<ul style="list-style-type: none"> <li>KoFIU guidelines should give clearer direction to the FSC/FSS in inspections of STR practices. The KoFIU should give greater feedback to the FSC/FSS on investigations proceeding from STRs. KoFIU should consider providing identified senior personnel at the FSC/FSS with controlled access to the file of the KoFIU's investigations deriving from STRs.</li> </ul>
Record keeping, compliance and audit	<ul style="list-style-type: none"> <li>Supervision of record keeping practices by the FSC/FSS should be enhanced, particularly with respect to banks and securities firms.</li> </ul>
Cooperation between supervisors/regulators and competent authorities	<ul style="list-style-type: none"> <li>Uncertainty as to the legal ability of FSC/FSS to provide customer information to foreign counterparts should be removed through a reinterpretation or amendment to the <i>Real Names Act</i>.</li> </ul>

<b>AML/CFT MEASURES IN THE BANKING SECTOR</b>	
Customer identification and due diligence	<ul style="list-style-type: none"> <li>FSC/FSS regulations should expand the customer identification and due diligence requirements for banks, particularly in the following areas: (i) conduct of more extensive due diligence in the case of high-risk customers; (ii) establishment of specific identification procedures when entering into activity with non-face-to-face customers; (iii) refusal to enter into or continue a correspondent bank relationship with a bank incorporated in a jurisdiction in which it has no physical presence and which is unaffiliated with a regulated financial group; (iv) paying particular attention when continuing relationships with respondent banks located in jurisdictions that do not apply sufficient AML/CFT measures; (v) paying particular attention to correspondent banking services for wire transfer services and with respect to correspondent accounts that might be used directly by third parties to transact business on their own behalf; and (vi) requiring that banks include accurate and meaningful originator information on funds transfers and related messages.</li> </ul>
Monitoring and reporting suspicious transactions	<ul style="list-style-type: none"> <li>A specific requirement that banks monitor accounts on a global consolidated basis should be incorporated into the Regulations on Supervision of Banking Business.</li> </ul>
Record keeping, compliance and audit	<ul style="list-style-type: none"> <li>The Regulation on Supervision of Banking Business should require that banking groups apply "Know Your Customer" standards on a global basis, including requirements for documentation, and compliance testing by the parent.</li> </ul>
Cooperation between supervisors/regulators and competent authorities	<ul style="list-style-type: none"> <li>Uncertainty as to the legal ability of FSC/FSS to provide customer information to foreign counterparts should be removed through a reinterpretation or amendment to the <i>Real Names Act</i>. Explicitly require the FSC/FSS to ensure that home jurisdiction supervisors have on a controlled basis access to information, including from onsite examinations, needed to verify foreign operations' compliance with "Know Your Customer" policies and procedures of the home jurisdiction.</li> </ul>
<b>AML/CFT MEASURES IN THE INSURANCE SECTOR</b>	
Customer identification and due diligence	<ul style="list-style-type: none"> <li>The FSC/FSS regulations should require that insurers have in place due diligence requirements along the lines of "Know Your Customer" rules. Additionally, insurers should be required to (i) determine that the insurance entity establishes to reasonable satisfaction that every verification subject relevant to the application for insurance business actually exists; (ii) require that the insurance entity does not enter into a business relationship or carry out a significant one-off transaction unless it is fully implementing the above systems; (iii) require that an insurance entity carries out verification in respect of the parties entering into the insurance contract; and (iv) if payments are to be made to persons other than the policyholder, the proposed recipients should be the subjects of verification.</li> </ul>
Monitoring and reporting suspicious transactions	<ul style="list-style-type: none"> <li>Impose specific requirements that insurers (i) are alert to the implications of the financial flows and transaction patterns of existing policyholders; (ii) are extra vigilant to the particular risks from the practice of buying and selling second hand endowment policies, as well as the use of single premium unit-linked policies; (iii) check any reinsurance or retrocession to ensure the monies are paid to bona fide re-insurance entities at rates commensurate with the risks underwritten; and (iv) have put in place internal reporting procedures.</li> </ul>
Record keeping, compliance and audit	<ul style="list-style-type: none"> <li>Specific requirements regarding documentation and record keeping should be imposed on insurers.</li> </ul>
<b>AML/CFT MEASURES IN THE SECURITIES SECTOR</b>	
Record keeping, compliance and audit	<ul style="list-style-type: none"> <li>For the internal compliance officer system to be effective, it is critical that a compliance officer have adequate resources to monitor firm activities and the authority to ensure that appropriate action is taken by the company against employees who violate FSC/FSS regulations or internal firm policies. The FSS should cover this issue in inspections of brokerage firms.</li> <li>Computation and reporting to the FSS of net capital should be required more frequently than once a month in order to enhance the effectiveness of the net capital ratio method as a systemic risk management tool.</li> </ul>

Cooperation with regulators and competent authorities	<ul style="list-style-type: none"><li>• Uncertainty as to the legal ability of FSC/FSS to provide customer information to foreign counterparts should be removed through a reinterpretation or amendment to the <i>Real Names Act</i>.</li><li>• Regulations should set out the parameters for access from the FSC/FSS of brokerage records by foreign counterparts.</li></ul>
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#### D. Authorities' response

208. The authorities provided the following comments:

##### Paragraph 194

“Korea has a unified financial sector regulatory and supervisory system in which the FSC and the FSS oversee the banking, securities, and insurance sectors.”

Since Korea was at its rudimentary stage with regard to implementing AML/CFT system, KoFIU had to imply imperative and unavoidable measures to perform the role of a coordinator among financial supervisory agencies, law enforcement agencies, and financial institutions. As the system stabilizes, relevant authorities are expected to play a prominent role within Korea's AML/CFT system.

As we view our current progress, the FSC/FSS, in terms of performing their inspection duties with respect to anti-money laundering system, are developing necessary manuals by using knowledge from their own field-experiences, as well as reflecting guidelines that KoFIU had provided to them. With respect to financial institutions, they strive to implement the AML/CFT system by spontaneously establishing a computerized monitoring system for identifying unusual or suspicious transactions.

##### Paragraph 204

“Although much progress has been made within the last year, the Korean AML/CFT system is still in its infancy.”

After conducting its own STR analysis, KoFIU disseminates the results to the law enforcement agency most closely connected with the underlying predicate offense. In the specific cases where STRs are connected with criminal activities originating from predicate offenses related to the soundness and transparency of the financial system, KoFIU sends the results of their analysis to the FSC/FSS.

The reason why STRs are only submitted to KoFIU in accordance with Korea's anti-money laundering legislation is to prevent other authorities from misusing the analysis result, which would be detrimental to sound financial activities by the general public.

##### Paragraph 205

“Under the FTRA, there is a monetary threshold on suspicious transaction reports of W 50 million/\$10,000.”



At the early stage of introducing the Suspicious Transaction Reporting (STR) system a less stringent threshold for suspicious transactions was introduced to minimize the burden by the public and financial institutions. As the system stabilizes, however, a plan to lower or abolish the threshold for suspicious transactions is being reviewed.

**Paragraph 207**

“CFT has not received requisite attention in the Korean AML/CFT system.”

Although there is the absence of ratification by Korea of the *International Convention for the Suppression of the Financing of Terrorism*, within its current legislation, Korea sufficiently implements international duties such as filing STR and criminalization of terrorist financing, as well as freezing terrorist assets.

Paying attention to terrorist financing issues, KoFIU plans to supplement *Guidelines* or *Examples of STR* with additional materials regarding terrorist financing.

Reference Principle	Recommended Action	Response
<b>LEGAL AND INSTITUTIONAL ARRANGEMENTS</b>		
Customer Due Diligence	<ul style="list-style-type: none"> <li>Extended customer identification provisions of the <i>Real Names Act</i> to branches or majority owned subsidiaries of Korean financial institutions</li> </ul>	Recently the competent office reinterpreted the relevant provision of the <i>Real Names Act</i> . As a result, customer identification provisions are extended to foreign branches of Korean financial institutions.
Suspicious Transactions Reporting	<ul style="list-style-type: none"> <li>The ₩ 50 million/\$10,000 threshold for the mandatory filing of STRs should be eliminated and replaced with a criterion of suspicion (explicated through guideline).</li> </ul>	Refer to the above section (3) of our response to Paragraph 205 of the draft ROSC.
AML/CFT Internal Controls	<ul style="list-style-type: none"> <li>The FTRA provisions on the STR Reporting Officer should be rationalized with the other provisions on internal controls and compliance officers in other laws and regulations</li> </ul>	Most financial institutions appoint the compliance officer controlling the overall issues of AML/CFT as a reporting officer. In addition, most compliance officers in financial institutions are at managerial level.
Process for Handling Disclosure of Financial Information and Intelligence	<ul style="list-style-type: none"> <li>Explicit restatement of (i) the legal protection of KoFIU employees and employees of regulatory/supervisory agencies for actions while carrying out their official duties; and (ii) the operational independence of the KoFIU from MOFE.</li> </ul>	Article 3 of the Financial Transaction Reports Act (FTRA) stipulates that KoFIU can independently carry out its duties, and MOFE is not entitled to draw on the budgetary allocation made to the KoFIU.

<b>FOR AML/CFT CORE CRITERIA</b>		
<b>Organization and Administrative Arrangements</b>	<ul style="list-style-type: none"><li>• The KoFIU should take a more proactive role in AML/CFT training and education within the supervisory agencies and FSPs.</li></ul>	<p>From December 2001 until January 2003, KoFIU provided a total of 32 training and education seminars.</p> <ul style="list-style-type: none"><li>- Consultation meeting with staff and compliance officers (18 occasions)</li><li>- Seminars on the AML system (4 occasions)</li><li>- Consultation meeting with Financial Supervisory Agency (3 occasions)</li><li>- Working-level employers of FIs (4 occasions)</li><li>- Tour conference of regional financial institutions (3 occasions)</li></ul>