

System Risk Management in Korea

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Macro vs. Micro

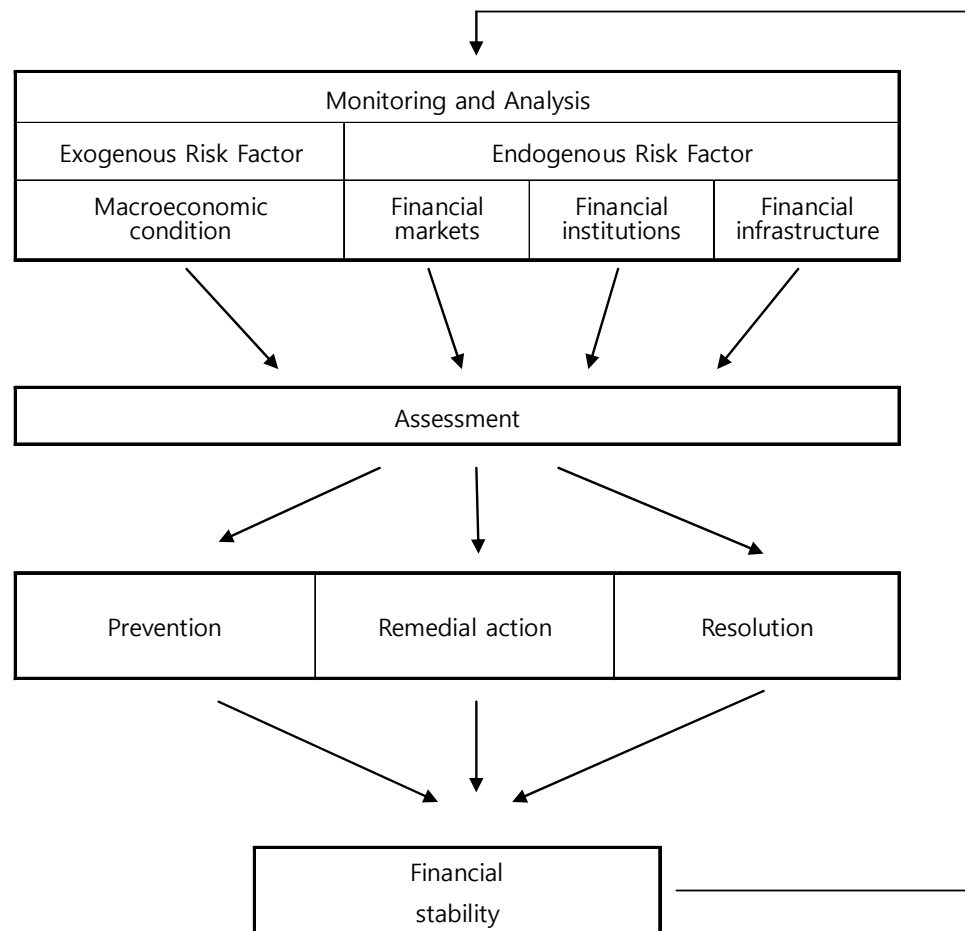
- Borio(2003) on prudential regulations
 - Macro- vs. micro-prudential regulation
 - Differences in three dimension: objective, risk characterization, risk management tools

	Micro-prudential	Macro-prudential
Regulatory objective	Consumer protection	Prevent system risk
Risk characterization	Exogenous risk Individual exposure	Endogenous risk Common exposure
Risk mgt tools	Institution level impacts	Economy-wide impacts

Why Macro-prudential Regulation?

- Protect broader spectrum of financial consumers
- Put more emphasis on the market than on an individual institution
- Soundness of individual institutions does not deliver system stability
- Changes in economic environment that made pro-cyclicality or common exposure more prevalent

System for Financial Stability



Source: Houben, Kakes, and Schinasi (2004)

Korean Case

- Ministry of Strategy and Finance – The Treasury
- Financial Services Commission – single financial regulator
- Financial Supervisory Services – examination and inspection
- Bank of Korea – central bank, regulation for financial stability
- Korea Deposit Insurance Cooperation – resolution of failed financial institutions (banks, insurance companies, security firms)

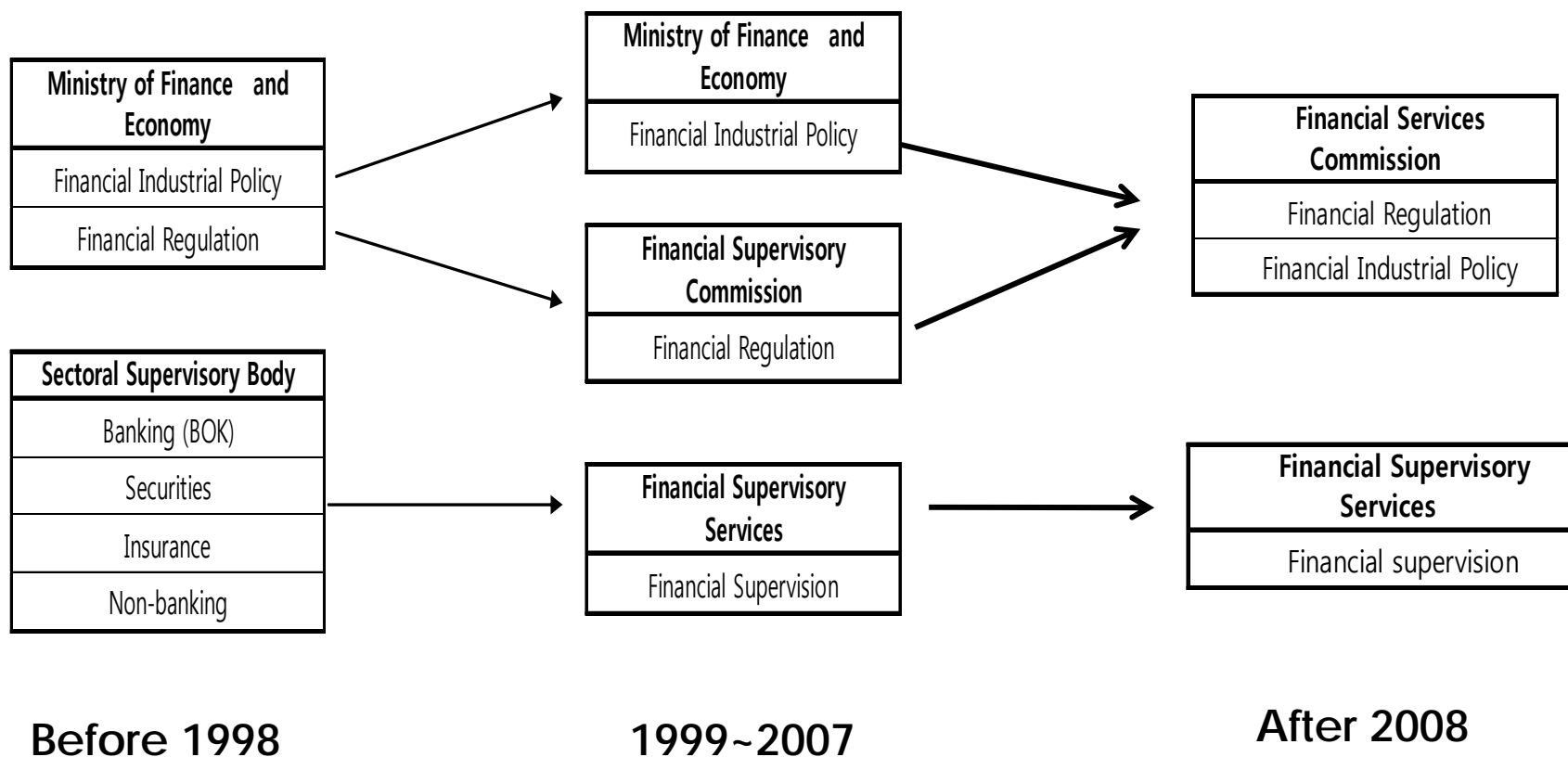
MoSF

- Holds big , though indirect, stake in maintaining financial stability.
 - Prime coordinator of macroeconomic policies
 - Has the duty to ensure stability in the economy as a whole
 - Financial stability is a crucial condition for economic stability.
 - Is not involved in the system directly on a daily basis

FSC

- Primary responsibility over financial stability
 - Single integrated regulator in Korea
 - A government organization under prime minister
 - Head is a government official at minister level
 - Has the duty to oversee implementation of all financial laws and to design policies on financial regulation
 - Rules and regulations
 - Does not conduct examination or inspection on individual institutions.
 - Also design and implement policies to promote the development of financial industry: industrial policy
 - Has the power to approve budget of FSS and to supervise its activities

Evolution of FSC



FSS

- Primary operational body in financial regulation
 - Conducts examinations and inspections under the general guidance of FSC
 - A civilian institution – expertise and independence from political pressure
 - Heavy emphasis on micro-prudential regulation

BOK

- Another important stakeholder in the system
 - Has the responsibility to maintain stable and efficient payment and settlement system – important financial infrastructure
 - Guardian of financial stability as the lender of the last resort – remedial measures
 - Possesses one of the most powerful macro-prudential regulatory tools – monetary policy
 - Produces information crucial to macro-prudential regulation to maintain financial stability

KDIC

- A publically-owned corporation in charge of deposit insurance system
 - Under the supervision of FSC
 - Take measures to resolve failed insured institutions
 - Has limited power to collect information on individual institutions and take regulatory measures

Assessments - 1

- Lack of clear legal demarcation on jurisdiction of each agencies
 - May result in dispute over jurisdiction and coordination failure.
 - Particularly problematic when the system is under stress
 - Example; BOK's role in financial stability system – how far should we recognize BOK's involvements?

Assessments - 2

- Bureaucratic dominance in the financial regulatory system
 - FSC as the rule setter and policy maker vs. FSS as the executor
 - When first established, FSC was nothing but a supporting unit staffed with a small size of bureaucrats.
 - Has transformed itself into a powerful agency with more than 200 bureaucrats in 5~6 years and dominate the arena of financial regulation.
 - Core argument: some important administrative functions – licensing and sanctioning - should not be exercised by civilians including FSS.

Assessments - 3

- Weak institutional arrangement for policy coordination and information sharing
 - The president can direct the formation of the Special Working group if deemed necessary under stress situation.
 - Consists of heads of MoSF, FSC, BOK, and relevant officials from the office of the president.
 - Discuss and coordinate economic (not simply financial) policies to cope with the situation
 - Under normal circumstances, No official channel through which agencies related to financial stability can share information and formulate coordinated policy measures.

Episode 1

- Battle between BOK and FSS (FSC) over amendment of BOK Act
 - BOK had constantly raised the discontents over its limited access to regulatory information.
 - Does not possess the power to inspect individual institutions without help/consent from FSC/FSS.
 - Acquires institutional level regulatory information from FSS – depends on agreements between two agencies.
 - Enhanced interests on macro-prudential regulation due to global financial crisis in 2008
 - BOK launched a campaign to gain broader access to micro-level regulatory information.
 - FSS forcefully opposed to the attempt citing the cost of duplicating regulation

Episode 1

- The discussion was stalled due to grave disagreement.
 - Presidential Commission to address the issue was formed in June 2009 and no significant conclusion was drawn.
- Bill to amend BOK Act was initiated in December 2009.
 - National Assembly was seriously divided over the issue.
 - The division of opinion was made not on party line but on committee affiliation.
 - State Affairs Committee in charge of FSC/FSS vs. Strategy and Finance Committee in charge of BOK
- Fierce territorial behaviors may result in serious problems especially if active macro-prudential regulation policy is pursued by multiple regulatory authorities.

Episode 2

- BOK's reluctance to participate in emergency measures to cope with crisis
 - MoSF initiated the establishment of BMSF (asset size 10 trillion Won) to cope with liquidity problem in bond market.
 - BOK was reluctant to contributing to the fund and announced contribution contingent on size of other participants' contribution.
 - The contribution constituted *de facto* emergency loans to private economic agents as well as banks.
 - BOK took an extremely conservative approach to the issue and was not willing to address it in a straightforward manner as stated in the law.

Episode 2

- Two possible interpretation on BOK's attitude
 - BOK took excessively cautious position to avoid responsibility as the lender of last resort.
 - It was an effort to maintain independence from political pressure.
- Possible side-effect of BOK's active involvement in macro-prudential regulation
 - May expose BOK to pressure from the government and political parties and do damage on independence.
 - Keeping price stability (inflation targeting) is the only mission explicitly acknowledged by the law and BOK frequently utilize the clause to shield itself from outside pressure and make independent decision on monetary policy.

Downs on Bureaucracy

■ Bureaucrat

- works for a large organization; receives a regular monetary compensation; hired, promoted, and retained based on role performance; produces outputs that cannot be valued through market mechanism

■ Categorization

- Self-interested bureaucrats: climbers, conservers
- Mixed motive bureaucrats: personal benefits + organizational/societal benefits
 - Zealots
 - Advocates
 - Statesmen

Downs on Bureaucracy

- One characterization of bureaucratic behavior
 - each bureau attempts to stake out, defend, and expand a certain “territory” of policy related to its social functions.
 - it is a continuous struggle with other bureaus to secure its territory in certain area over which multiple organizations claim jurisdictions.
 - On the other hand, **if society does not apply a strong pressure** on bureaucratic organizations to formulate a well coordinated policy settlement, they may avoid territorial battles by simply paying no attentions to each other even though a coordinated policy initiative is called for from society’s point of view.

BOK vs. FSS

- Turf war on jurisdiction over macro-prudential regulation between BOK and FSS
 - In reality, struggle over supervisory (inspection, examination) power over financial institutions
 - A typical example of territorial conflicts by competing bureaus/bureaucrats
- A possible solution
 - Action by the National Assembly through moral suasion/mediation/enactment

Turf War in the NA

- Congressional committee system
 - Source of turf war over jurisdiction in the NA: King (1994)
 - BOK - the Strategy and Finance Committee vs. FSC/FSS- the State Affairs Committee
- Impasse?
 - May utilize independent expert panel with bi-partisan initiative in the NA
 - Ask the panel to produce the final report with concrete recommendations,

Suggested Changes

- Yun and Jung (2010)
 - Establish 'Committee For financial Stability' as the control tower for policy coordination and smooth information flow
 - All parties related to financial stability should participate.
- Kim (2009)
 - Division of labor by BOK and FSC/FSS
 - Judgment on system crisis by BOK
 - Action by FSC/FSS

Not “What” But “How”

- It is not the matter of what to do but of how to do!
 - Many “good” and “workable” remedies have already been suggested to achieve better system for financial stability.
 - Presidential Commission in 2009
 - We need change the current system. The system has flaws that should be taken care of.
 - But, not now! It is crisis time.
 - It will take more time and discussion.

the High-level Group on Financial Supervision

- Expert panel commissioned by both EC and European Parliament
 - Recommend establishment of a European System Risk Board (ESRB) as a systemic risk regulator .

System vs. Culture

- It takes more than system/institutions to achieve financial stability.
- It is human that makes the system/institutions work.
 - Coordination and information exchange are important pre-conditions for successful division of labor.
 - Bureaucratic features may make themselves more conspicuous in maturing societies rather than matured ones.
 - Nurturing culture for cooperation to achieve better results is no less important than building good institutions.