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The Korea Banking Risk Dialogue

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Contents

In Attendance

The session was attended by the following:

1. Sungwoo (Brian) Kim, Head of BCBS Team, Bank Supervision Department, Financial Supervisory Service (FSS)
2. Brian Cahill, Head of Scenario and Stress Testing, HSBC Hong Kong
3. Byunghyun Ahn, Chief Risk Officer, Hana Finance Group
4. Chang Ho Yang, Head of Compliance, Suhyup Bank
5. Kiscoo Ahn, Head of Risk Management, Woori Finance Holdings
6. Donghyun (Tom) Park, Principal Economist Macroeconomics and Finance Research, The Asian Development Bank
7. Bohyuk Yim, Chief Risk Officer, Shinhan Finance Group
8. Jongmin Kim, Senior Manager of Operational Risk, Kookmin Bank
9. Sung Kwan Jang, Head of Risk Management, Jeonbuk Bank
10. Yongrok Choi, Professor, Inha University
11. Dong-Sung Lee, Senior Manager of Financial Management, Kookmin Bank
12. Soo-jin Lee, Senior Manager of Credit Risk, Kookmin Bank
13. SiYeol Choi, Team Manager of Consulting Division, Korea Asset Pricing
14. Kun-Yong Yun, Vice Research Fellow of Financial Research Division, Nonghyup Economics Research Institute
15. Jaehee Cho, Head of Risk Management, Shinhan Bank
16. Hyungnam Moon, Professor of Graduate School of Information and Communication, Sookmyung Womens University
17. Chulwoo Han, Partner and CEO of CMPR, TriOptima Asia Pacific
18. Yutaka Imanishi, CEO, TriOptima Asia Pacific
19. John Chiah, Head of TriReduce, TriOptima Asia Pacific
20. JongKyun Kim, Partner, IBM GBS
21. Seana Chun, Senior Solutions Consultant, SunGard
22. Emmanuel Daniel, President and CEO, The Asian Banker
23. David Millar, Risk Management Specialist, COO of the Professional Risk Managers' International Association (PRMIA)

Key Discussion Points

The following key discussion points were distilled from the dialogue and are expanded on below:

1. South Korean banks' risk managers are facing three main risk and regulatory issues.
2. Impact of current global geo-economic developments on the financial industry.
3. The impact of enforcing regulations on banks.
4. Credit Valuation Adjustment (CVA) involvement in Basel III regulations.
5. Banks are looking into risk management alternatives.
6. Global Systemically Important Financial Institutions (G-SIFIs) in South Korea and the direction they are heading.
7. Compressing and reconciliation of the portfolio is a popular way to prepare it for optimisation.
8. Major changes in the OTC derivatives market in South Korea
9. Implementation and other potential issues with Basel III
10. Practical advice on preparing for Basel III

Detailed Key Discussion Points

The following detailed discussion points represent the contribution of all the participants.

1. South Korean banks' risk managers are facing three main risk and regulatory issues.

a) The three main rating agencies (Moody's, Standard & Poor's and Fitch Group) have boosted the credit ratings of South Korea - this has allowed a surge of foreign currencies into the economy, leading to new restrictions placed by national regulations, and thus complicating the derivatives markets.

b) Impending Basel III capital and liquidity requirements have caused South Korean banks to be more conservative in their lending, not because of the capital requirements as much as the slowing economy.

c) Capital and lending developments have major impacts on counterparty risk such as forcing banks to improve their risk governance increase their stress testing.

2. Impact of current global geo-economic developments on the financial industry.

a) The global economy is at its worst since the Great Depression with growth figures of developing countries (e.g. China and India) in Asia starting from 7.2% in 2011 and falling to 6.1% in 2012 and then estimated to stay at a low in 2013.

b) The South Korean won has become the best performing currency in Asia since June 30 2012, rising about 9% against the US dollar over the past six months. The expensive exports have thus contributed to the country's weak growth, which in turn tempered the inflation level that is forecasted to be at 4.2% in 2012 and 2013 across Asia.

c) Development of regulations in advanced economics and heightened global uncertainties could prompt volatile capital flows. Furthermore, with liquidity drying up in the financial industry, the dampened ability to borrow and grow will adversely impact all corporates. However, East Asia is still growing steadily, with opportunities for growth and expansion.

d) Across Asia, in countries such as China, South Korea, and Mongolia, non-performing loans (NPLs) are climbing to alarming levels. The poor NPL ratios are caused by weak manufacturing and trough housing prices in South Korea as well as in China.

e) South Korea's traditional sectors were severely affected by the Eurozone crisis, with the country among those most exposed to Europe's economic problems. Thus, South Korea's economy could potentially tank if the crisis worsens.

f) However, development of the service sector in Asia will bring forth new opportunities, such as positive spillover to other business sectors, support for greater inclusiveness, and new opportunities for foreign trade.

3. The impact of enforcing regulations on banks.

a) The slew of new regulations is forcing banks to completely restructure their compliance and risk management departments, which has proved expensive and time consuming.

b) Banks are frequently stress testing across wide sets of data and are required to gather more timely and accurate information for regulators.

c) South Korean risk managers are interested in learning about best practices for their departments to help them maintain a healthy return on investment (ROI) and gain an optimal level of risk as the world's economy continues to rebuild itself after the 2008-2009 global financial crisis.

4. Credit Valuation Adjustment (CVA) involvement in Basel III regulations.

CVA is the capital imposed on the risk of loss due to the credit rating downgrade of a counterparty in addition to default risk related to over-the-counter (OTC) derivatives.

a) Banks that have failed to gain approval for CVA risk capital calculation on the counterparty should calculate the imposed capital on the portfolio.

b) The fact is that roughly two-thirds of CCR losses were due to CVA losses while only one-third was due to actual defaults.

c) Banks in general are concerned about the levels of CVA charges that they should hold. While banks are focused on CVA as a specific case of risk management, it also directs the IT departments to modernise risk management systems.

d) Counterparty credit risk (CCR) has transitioned from passive to active risk management in recent years and it requires ever more accurate and frequent CVA calculations - daily, intraday, and real time.

5. Banks are looking into risk management alternatives.

External forces cannot be blamed on its entirety for issues that affect Asia's financial sector. South Korean life insurers have been issuing a record-high policy guarantees and are thus seeking alternatives in hedging these long-dated liabilities. The solution appears to be a drive for yield, with firms looking to solve their problems through asset outperformance – in the current economic climate, this appears to be a bold approach.

a) The alternative strategies and tactics for risk management involve the use of the following:
   i. Policy decisions - This is made up of business policy decisions made by management teams in their on-going efforts to bring their banks to positive performance levels.
   ii. Practices around pricing and risk management of counterparty risk - These create second and third order ripples through the industry, extending to buy-side and corporate derivatives end users.
   iii. Cash market transactions - This category is made up of conversational transactions management teams employed to manage their companies' balance sheets in conformance with industry practices and regulatory guidelines.

iv. Derivatives - These financial instruments have been derived from the underlying characteristics and liabilities that make up companies' risk position on their balance sheets or portfolios.

6. Global Systemically Important Financial Institutions (G-SIFIs) in South Korea and the direction they are heading.

The Basel Committee on Basel Supervision (BCBS) has already finalised the regulatory framework for G-SIFIs. However, no financial institution in South Korea is qualified as a G-SIFI at present.

a) Issues remain as to whether or not a bank's parent company will be permitted to hold contingent convertible bonds (CoCos) raised by its South Korean subsidiary as its own supplemental capital and how much it will be allowed to hold if permitted. These issues have not yet been clearly addressed.

7. Compressing and reconciliation of the portfolio is a popular way to prepare it for optimisation.

The achievement of an optimal portfolio balance will boost liquidity, capital and profitability. Many institutions run their reconciliation against CCPs, such proactive reconciliation enables the essential alignment of information of the bank's portfolio to that of its counterparties and CCPs. Portfolio compression, on the other hand, allows banks to terminate large parts of existing contracts early while keeping its market risk profile, counterparty exposure and cash position in control.

a) Portfolio reconciliation and compression have become market standards for OTC derivatives post-trade risk mitigation. Furthermore, they were imposed in rules and requirements in the European Union and in US.

b) Portfolio compression reduces outstanding notional amount both in bilateral relations and central counterparties (CCPs). The reduction of outstanding notional and number of transaction leads to:
   i. Reduction of operational risk and costs.
   ii. Better management of CCR.
   iii. Elimination of risk weighted assets (RWAs) from balance sheet.
   iv. Reduction of capital market charges.

c) Multilateral portfolio compression has long been employed as a tool for banks to manage their OTC derivatives risks and costs and its importance has increased under Basel III and other new regulations.

d) Portfolio reconciliation is an essential post execution risk management technique designed to proactively identify and resolve discrepancies between counterparties throughout the lifetime of a transaction. There have been a large number of reconciliations done with Asian companies in the last 12 months, with one of the largest performed in Australia and Japan.

8. Major changes in the OTC derivatives market in South Korea

a) The lack of liquidity in the South Korean OTC derivatives market presents developments and challenges in CCR, operational risk, systemic risk and margin risk.

b) OTC derivatives incur a number of costs because they have a longer life cycle till maturity, which can last up to 50 years, unlike cash transactions, which expire upon execution. Such costs include regulatory/economic capital charges, CVA charges, operational costs, funding costs as well as additional costs involved in operational activities.

9. Implementation and other potential issues with Basel III

a) The majority of South Korean banks had concerns about various aspects of Basel III such as the stringent capital requirements, the global market for OTCs and clearer ways to optimise their portfolios.

b) South Korean banks are having difficulty in meeting the Liquidity Coverage Ratio (LCR) requirement and financial regulators have been repeatedly issuing warnings about compliance. Under Basel III, only corporate bonds with a credit rating equal to or higher than AA- by a recognised external credit assessment institution will be eligible for the purpose of measuring liquidity. As South Korea has a grade 'A' sovereign rating for overseas debt, many of the overseas bonds issued by local entities could not qualify as liquid assets under Basel III.

c) Legal entity reorganisation (which has been a big problem in the US and Europe) has not yet become an issue in South Korea. This is because the significance of banks within a financial holding company is much greater than that of other non-banking financial units, and thus financial groups' reorganisation in order to segregate the proprietary trading section is rather insignificant.

d) Basel III regulations affected the US and Europe differently than it did Asia; capital buffers and leverage ratios were issues of concern for western banks, whereas Asian banks worried about liquidity ratios and CCR charges.

e) Major Asian countries have taken different measures to prepare for Basel III rules. South Korea had liquidity rules put into effect, but the central clearing system was delayed.

   Japanese banks upgraded their risk models and improved pricings in the market, while also improving central clearing capabilities. Meanwhile, China published its final Basel III guidelines but will delay some parts of the implementation process.

10. Practical advice on preparing for Basel III

a) The quality of data is equally as important as quantity, thus banks need new data feeds (internal and external) and a centralised data warehouse. Moreover, there should be more granularity, types and volumes (liquidity rules and CCPs) of data.

b) The IT architecture that handles banks' data will have to be altered to accommodate data interdependencies from multiple sources to consolidate data as well as more advanced enterprise risk management (ERM) systems to capture complex analytics and improve on real time reporting.

c) Banks' risk methodologies and infrastructures will have to change as increasingly complex risk calculations (e.g. new leverage and liquidity metrics and frequencies) and even more substantive reporting requirements are needed.

Conclusion

a) The influx of new and complex regulations, a weak western market, and the need to compete effectively are key drivers fuelling South Korean banks to find new ways to become Basel III compliant.

b) South Korean banks weathered the 2009 economic crisis; however, they still face major challenges, such as meeting the LCR requirement, monitoring their exposure to international financial shocks and in keeping their ROIs high in a very liquid market.

c) The lack of liquidity in OTC derivatives markets poses serious challenges to South Korean banks in terms of counterparty risk, operational risk, systemic risk, and margin risk. The key to solving some of these problems is to restructure banks' risk departments to better monitor these prevailing risks.

d) South Korean banks are going to have to continue enhancing their risk management processes, implement advanced technologies that are able read and analyse wide sets of data from the different departments of a bank, and continuously optimise their portfolios. South Korean banks will have to use more sophisticated analytics (MC simulation) and faster computations, including CVA, debt valuation adjustment, funding value adjustment, and overnight index swaps.