

July 2<sup>nd</sup>, 2014

## Proceedings Report

Seoul, South Korea

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## Introduction

1. The Asian Banker held the Korea Banking Risk Dialogue on July 2, in Seoul, Korea. It brought together both international players as well as senior Korean professionals in a serious and frank dialogue on the opportunities and challenges arising from adapting risk management infrastructure and processes to new regulatory requirements and technologies.
2. The following report summarises the central points presented by the key speakers of each session, including main issues discussed, as well as the Question and Answer session that followed.
3. The objectives of the dialogue were to:
  - i. Discuss regulatory priorities and banking trends for Korea in 2014-2015.
  - ii. Examine recent developments in US financial crime enforcement and implications for Asia.
  - iii. Assess Korean priorities in market risks and the trading book.
  - iv. Review the evolving global OTC derivatives market.
  - v. Evaluate operational risk transformation in light of Basel III.

## In Attendance

The session was attended by the following:

1. **Sungwoo Kim**, Head BCBS Team, Bank Supervision Department, Financial Supervisory Service
2. **Jimmy Gurule**, former Under Secretary for financial crime, US Department of the Treasury
3. **Yutaka Imanishi**, CEO Asia Pacific, TriOptima
4. **Byungsu Yim**, CRO, KB Kookmin Bank
5. **Jaejoong Kwon**, CRO, Shinhan Bank
6. **Kwanghoon Kim**, CRO, NH Nonghyup Bank
7. **Hyunpil Moon**, CRO, Kwangju Bank
8. **Chaegon Kim**, General manager of Credit Risk Review Department, Kookmin Bank
9. **Joongwan Myung**, Director of Risk Management, Shinhan BNP Paribas
10. **Hyunggeun Park**, General manager of Risk Management, Korea Development Bank
11. **Hyunsook Park**, General manager of Compliance Department, Standard Chartered Bank Korea
12. **Yunsoo Park**, General manager of Risk Management, Woori Financial Group
13. **Kwangwook Jeon**, Head of Compliance, Industry Bank of Korea
14. **Jaejun Lim**, General manager of Liquidation payments operations team, KRX
15. **Pilhee Park**, Team leader of Risk Review Department, Industry Bank of Korea
16. **Donghwa Shin**, Team leader of Market Risk Management, NH Nonghyup Bank
17. **Jong-Bom Chay**, Dean-School of Business, Sung Kyun Kwan University (SKKU)
18. **Patrick Chew**, Head, Operational Risk, OCBC Bank
19. **Cesar Mora**, Senior Manager, Risk Analytics, IBM
20. **Gordian Gaeta**, International Resource director, The Asian Banker

## Key Discussion Points

The following key discussion points were drawn from the dialogue and expanded below:

1. Regulatory priorities and banking trends for Korea in 2014-2015
2. Recent developments in US financial crime enforcement
3. Fundamental review of the trading book
4. Portfolio compression as effective risk mitigation tools
5. Operational Risk Transformation – A Singapore Case Study

## Detailed Discussion Points

The following detailed discussion points represent the contribution of all participants

### 1. Regulatory priorities and banking trends for Korea in 2014-2015

- a) As a regulator Korea's Financial Supervisory Service (FSS) considers it important for domestic banks to manage their risk exposures to China.
- b) Non-interest income of Korean banks is around 4-5 percent compared with U.S. banks that have managed to generate an estimated 40 percent in non-interest income.
- c) Local banks continue to register declines in profitability as identification of new sources of income becomes critical to their long-term viability.
- d) Korean household debt is presently 150 to 160 percent of disposable income; the FSS proposes to increase the fixed rate, amortise loans, raise risk weight on roll over of bullet payment loans and support legislation on covered bonds to effectively control it.
- e) The FSS is committed to providing adequate consumer protection without undermining the operational profitability of the domestic banking industry.
- f) If Korean banks fail in their effective management of internal modelling then the FSS will take disciplinary action.
- g) Global risk factors that remain a concern are the reduction of quantitative easing in the U.S., impact of Japan's *Abenomics* and China's purported soft landing.

### 2. Recent developments in US financial crime enforcement

- a) The Obama administration has taken an aggressive posture regarding the imposition of sanctions against banks for non-compliance with U.S. economic sanctions and bank secrecy laws.
- b) Bank misconduct is no longer limited to non-compliance with U.S. economic sanctions as envisaged under the International Emergency Economic Powers Act ("IEEPA") and the Trading with the Enemy Act ("TWEA").
- c) U.S. Department of Justice (DOJ) has signaled a fundamental policy shift away from entering into deferred prosecution agreements (DPAs) with offending banks in favor of criminal prosecution.
- d) There has been strong vocal criticism of the DOJ for failing to shut down offending banks or charge any bank official with criminal wrongdoing.
- e) Most recently, the DOJ fined BNP Paribas \$8.9bn and suspended clearing clients' dollar transactions for up to one year, representing a significant departure from DPAs.

- f) The centerpiece of the federal regulatory regime established by the Bank Secrecy Act (BSA), and amended by the USA PATRIOT Act, is the requirement that financial institutions establish, implement, and maintain a program to detect and prevent money laundering and terrorist financing.
- g) Virtually every bank that has been sanctioned by the Financial Crimes Enforcement Network ("FinCEN") or the DOJ for violations of the BSA or economic sanctions has been penalized for failing to file SARs.
- h) Factors contributing to the non-compliance of banks in filing SAR requirements are: (1) lack of adequate employee training; lack of clear and expeditious procedures for determining whether a suspicious transaction should be reported to the Treasury Department; and senior management's failure to fully embrace and communicate the importance of SAR reporting.
- i) The principle of "know your customer" (KYC) has been the backbone of anti-money laundering and counter terrorist financing measures by financial service providers.
- j) Under the BSA, financial institutions, including foreign banks with U.S. branches, are required to implement reasonable procedures for identification and verification of customers opening an account.

### **3. Fundamental review of the trading book (FRTB)**

- a) FRTB is primarily a move from the regulators to deliver consistency to the market risk risk-weighted assets (RWA) treatment, introducing a stricter regime of market risk governance.
- b) The current standardized approach's shortfalls include a lack of risk sensitivity, a very limited recognition of hedging and diversification benefits and an inability to sufficiently capture risks associated with more complex instruments.
- c) The proposed revised standardized approach will consider either a sensitivity based approach (SBA) or an adjusted cash flow approach (ACFA).
- d) FRTB will eventually affect all banks whether they use the internal model approach (IMA) for risk assessment or not.
- e) A potentially higher market risk capital charge for banks utilizing the IMA is credited to narrower definition of what falls within the trading book, limited benefit of diversification between asset classes and longer liquidity horizons
- f) Trading desks that do not receive IMA will be capitalised using the revised standardised approach; risk factors with no modelling approval to be capitalised using stress testing and securitised transactions will be capitalised using the revised standardised approach.
- g) Application of FRTB will require approval & continuous monitoring at the desk and risk factor level with well-defined policies and procedures in place.
- h) FRTB mandates more granular and comprehensive reporting where banks using models-based approaches will have to report risk capital numbers, using both standardised and internal models based approaches, and set disclosure requirements regarding the trading book composition.

### **4. Evolving global OTC derivatives market**

- a) OTC derivatives incur various risks during their life cycle namely: counterparty credit risk (CCR), operational risk and systemic risk and margin disputes; the most critical being CCR.
- b) Banks with uncollateralized portfolios continue to face the highest risks.

- c) Regulatory jurisdictions have attempted to mitigate such risk through use of central counterparties (CCPs), identification of RWA, use of collateral agreements (CSA), application of regulatory capital and CVA charges.
- d) There are serious costs involved in the operational and execution of the various risk mitigation techniques.
- e) Concentration risk build-up in CCPs remains an ongoing concern given the transfer of CCRs to designated CCPs.
- f) Portfolio reconciliation and compression techniques have become market standards for OTC derivative post-trade risk mitigation.
- g) Asian regulators are considering it as a best practice guideline for regulating their own financial institutions.
- h) Portfolio reconciliation is a process that compares the transaction records of two counterparties as of a given business date to ensure that both counterparties have an accurate record of the trades in their data systems.
- i) OTC derivative trades are now required to be reported to respective trade repositories so as to facilitate transparency and help identify any build-up of systemic risk.
- j) Post-trade portfolio reconciliation enables banks to ascertain composition and valuation of its portfolio while matching with counterparties and CCPs.
- k) Post-trade portfolio compression allows banks to terminate large part of existing contracts early while keeping market risk profile unchanged. More importantly counterparty risk exposure and cash position is continuously monitored and controlled.
- l) Balancing risk in a CCP environment is possible as banks employ portfolio compression to flatten risk exposure with all counterparties.
- m) Adoption of portfolio reconciliation & compression techniques by Korean banks is non-existent. Substantial potential for termination of outstanding notional amounts remains.
- n) There has been considerable growth in the number of reconciliations executed by Asian financial institutions over the preceding 12 months.

## **5. Operational Risk Management (ORM) perspectives.**

- a) The existing volatile global economic landscape challenges organizations with increasing level of complexity and uncertainty.
- b) The importance of ORM is underlined by extended financial crises and corporate failures.
- c) The modus operandi of financial crime is evolving in scale, scope and severity mandating a constant review of business continuity and crisis management plans.
- d) Meeting the escalating expectations of regulators is critical in preserving corporate reputation.

## **Conclusion**

- Domestic household debt, illiquidity of conglomerates, banking industry profitability and financial institutions' internal controls are all significant contributors to the country's risk profile.
- If the FSS detects discrepancies in its industry stress test and the bank's stand-alone stress test then it will consider the bank's internal modelling for risk measurement as having failed.
- Criminal prosecution of banks officials who willfully engage in money laundering and violate U.S. economic sanctions is likely forthcoming.

- The failure to file Suspicious Activity Reports (SARs), or file them on a timely basis, is the Achilles heel of bank AML compliance programs in the U.S.
- Portfolio compression is considered to be more effective and efficient than bilateral cancellation that requires negotiating with respective counterparties one by one.
- Portfolio compression reduces outstanding notional enabling improved management of counterparty credit risk and associated costs.
- Preventing and detecting financial malfeasance and fraud remain a priority of operational risk managers.

## Photos of Dialogue





## Contact Information

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