Best Practices in Preventing and Monitoring Systemic Risk

Ilhwan Kim
Bank of Korea

<Summary>

Among the causes of the recent global financial crisis, we may single out the lax regulation of hedge funds and large unregulated non-bank financial institutions (NFIs) and the consequent “high risk/high yield” business model.

In Korea, only a few hedge funds have a domestic market presence and their way of doing business has had little influence on the financial market. In the past, however, we had experience of systemic risk arising owing to the relatively more relaxed regulatory regime applied to large NFIs such as merchant banking corporations (MBCs) and credit card companies (CCCs) than to banks themselves.

Therefore, in my presentation, I shall examine the systemic risk generated by the reckless way in which MBCs and CCCs operated in Korea and look at the measures adopted by the policy authorities in response. Then, on the basis of our experience, I shall draw on it in order to consider best practices in preventing and monitoring systemic risk.

MBCs, as the highly-leveraged NFIs in Korea before the 1997 currency crisis, are believed to have triggered the crisis, due to their severe maturity mismatches and expansion of more risky business areas. The loosening of regulations also triggered the currency crisis in some sense, causing MBCs' deterioration. The policy authorities did not establish a systematic financial supervisory and regulatory framework. They also did not regulate MBCs' business activities sufficiently.

The number of CCCs increased substantially in Korea after the 1997 currency crisis, owing to the growth of retail financing and expectations of higher returns in the credit card market. However, the policy authorities' institutional support and financial deregulation for the purpose of boosting the credit card market resulted in the

generation of a credit card bubble. This bubble burst in 2003, so the financial conditions of CCCs deteriorated dramatically.

The irresponsible business models and ways of running operations of large unregulated NFIs may lead to systemic risk. This can bring about heavy social costs in that the resulting financial market unrest can give rise to financial crisis or financial panic.

In the light of our experience related to systemic risk arising from NFIs' deterioration in Korea, the following best practices can be considered.
First, construct and operate internal control systems based on risk management. It is very important to bring about recognition of risk management as a core element of the business operations of NFIs. To this end, their routine construction of risk management systems should be encouraged and a regime put in place to confirm compliance at regular intervals. Second, strengthen prudential supervision and regulate financial institution soundness. A risk-based supervisory framework should be introduced and they should be subject to the same level of supervision as banks. Third, heighten the transparency of financial institution management information. The scope for disclosure of NFIs' management information should be expanded and accounting standards revised on a systematic basis. In tandem with this, the information should be promptly made available to market participants. Fourth, impose liability on the majority shareholder of NFIs. In order to avoid moral hazard on the part of market participants, the majority shareholders should bear the liability for failed financial institutions and make up a considerable part of management losses. In Korea when support was provided for the rehabilitation of troubled CCCs, recapitalization was undertaken by large shareholders held liable for management failure. Fifth, the policy authorities may have to intervene directly in order to safeguard financial system stability by acting as an orchestrator. If NFIs failed, the policy authorities should swiftly divide them into those that are systemically important and those that are not. Then, in order to prevent contagion effects, support for a turnaround can be given to those paths of systemically important through the supply of liquidity whereas the remaining institutions should exit the market.