Seung Park: Korea's experience in the choice of bank supervisory arrangements

Speech by Dr Seung Park, Governor of the Bank of Korea, at the 39th SEACEN Governors' Conference, Colombo, Sri Lanka, 12 February 2004.

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1. Introduction

This afternoon, I would like to talk about Korea's experience in the reform of the financial supervisory system.

In April 1998, Korea established an integrated financial supervisory body responsible for banking, securities, and insurance. As you may be well aware, the United Kingdom and Japan launched integrated financial supervisory systems : the U.K. in October 1997 and Japan in June 1998. In some ways, therefore, Korea was going along with a new international trend toward bringing together financial supervision within a single agency.

The Republic of China, and Governor Fai-nan Perng will correct me if I am wrong, intends to set up an integrated financial supervisory body this July. And the People's Republic of China has, meanwhile, stripped the central bank of its bank supervisory function and established a separate bank supervisory agency.

In most other SEACEN member countries, I understand that the central bank exercises the function of bank supervision. So I think that my fellow governors may have a deep interest in proposals to establish a separate financial supervisory body.

I believe that Korea's experience, in this regard, may be of some help to you in this area. Let me now express my deep thanks to our gracious host, Governor Jayawardena, for providing me with this opportunity.

2. Establishment of integrated financial supervisory agency

The financial supervisory system prior to integration

Until the 1998 reorganization, Korea had several supervisory bodies responsible for different types of financial institutions. The Office of Bank Supervision of the Bank of Korea(BOK) supervised commercial banks. It authorized the market entry of new banks, laid down prudential regulations, held on-site examinations, and exercised discipline over them. Two other major supervisory bodies were the Securities Supervisory Board responsible for securities companies and the Insurance Supervisory Board, the insurance company watchdog. Both these supervisory bodies came under the direction of the Ministry of Finance and Economy(MOFE).

Debate over the integration of financial supervisory bodies

Great changes had, however, been taking place in the financial institutions' operating environment particularly since the mid 1990s.

Following Korea's admission to the OECD in late 1996, competition in the Korean financial market became fiercer and fiercer as the financial and capital markets were thrown open in line with OECD criteria. Banks, securities companies and insurance companies all sought to expand their turf and the linkages between them grew much closer. As enterprises had more transactions with various types of financial institutions, money flows grew increasingly complex.

Meanwhile, the scale of the Korean economy was expanding and its structure becoming more complicated. An important new task emerged : that of rolling back government intervention in the economy in the name of improved efficiency.

From early 1997, the Korean government began to press ahead with financial reforms to bring together the various independent supervisory bodies under a single roof. It also sought to strengthen the BOK's independence in monetary policy. The government's steps toward the establishment of an integrated financial supervisory body naturally ignited a debate on the idea of taking away the central bank's bank supervisory function. The BOK at that time strongly opposed such government's plans.

Firstly, as lender of last resort, the central bank had to be in a position to monitor the insolvency and liquidity status of banks. This was also necessary for it to secure the stability of the payment and settlement system. Therefore it was essential for the BOK to keep bank supervisory function.

Secondly, it stressed that the politically neutral central bank should carry out bank supervision, a process that needs to be shielded from political pressure. It was also more efficient if bank supervision remained entrusted to the BOK, which already possessed the adequate human and physical resources.

The government, for its part, advocated that bank supervision had to be separated from the BOK because of conflicts of interest that might arise between monetary policy and supervisory policy. For example, if the central bank eased monetary policy to maintain financial stability, this could damage price stability which was the core goal of the central bank. Furthermore, the government pointed to worries that the central bank might become overly powerful, if it were to retain the right to supervise banks while being granted independence in monetary policy.

The plan to establish an integrated supervisory body became bogged down because of the clash of opinions between the BOK and the government. It gained a new lease of life, though, once the situation took a new turn in the aftermath of the outbreak of the currency crisis in late 1997.

In view of the urgent need for prompt financial sector restructuring, the IMF recommended the setting-up of an integrated financial supervisory agency to the Korean government. An MOU was consequently drawn up between them concerning its establishment in December 1997.

The National Assembly late that month passed the necessary legislation to remove bank supervision function from the BOK and establish an integrated financial supervisory body. This was duly set up in April 1998. The BOK consequently lost its bank supervisory function. Some 650 members who had been working in its bank supervisory field moved over to the new integrated agency.

In tandem with the passage of the new legislation for the financial supervisory system, the Bank of Korea Act was revised so as to give the central bank a greater degree of independence in monetary policy.

Previously the finance minister had been the chairman of the central bank's policy-setting body. Under the revised Act, the central bank governor became its chairman. Consequently, the policy setting body, the Monetary Policy Committee, was able to make decisions on monetary policy without prior consultation with the government.

Overview of the integrated financial supervisory system

Now, I would like to move on to explain the workings of the integrated financial supervisory system in its present form.

The Korean financial supervisory agency is made up of the Financial Supervisory Commission(FSC) and the Financial Supervisory Service(FSS).

The FSC is a collegiate administrative body under the control of the Prime Minister. It is the supreme decision-making organ in relation to financial supervision and examination. As such, it has the authority to direct the operations of the FSS and exercise surveillance over it. The Commission consists of nine members, and its chairman is appointed by the President for a three-year term. It is served by a secretariat made up of public officials. Under the FSC's direction, the FSS, a non-governmental organization and special juridical person having no capital, supervises and examines financial institutions. The Chairman of the FSC serves concurrently as the Governor of the FSS.

In the meantime, the BOK, the MOFE and the Korea Deposit Insurance Corporation(KDIC) exercise some limited supervisory functions in relation to those businesses falling within their particular areas of competence.

For its part, the BOK has the right to request individual banking institutions to submit materials about their business to check their actual management status. It may also require the FSS to examine banking institutions or to have its own staff participate on a joint basis in such examinations. Another connection is that the Deputy Governor of the BOK serves as an ex-officio member of the FSC. Consequently, he takes part in the decision-making process concerning financial supervisory policy.

To perform these tasks efficiently, the BOK established a Banking Institutions Department, which currently comprises a staff of 57.

The MOFE has the right to present draft bills relating to finance and supervision to the National Assembly. It is, however, required to consult with the FSC before proposing or revising such legislation. The KDIC, meanwhile, has the right to investigate the business status and assets of financial institutions thought to be in danger of failure. Like the BOK, it has the right to request that the FSS undertake the examination of financial institutions or allow its own staff to take part in joint examinations with that body.

3. Evaluation of the current financial supervisory system

Six years have passed since the integrated financial supervisory body was established in Korea.

During this period, the Korean financial industry has undergone intensive and far-reaching restructuring. The number of banks fell to 19 as of today from 33 in December 1997. The number of bank employees meanwhile declined by about 30 percent. Non-banking financial institutions have experienced an equally dramatic process of restructuring.

The integrated supervisory agency has been highly rated for its role in helping to overcome the currency crisis and improving the soundness of financial institutions through the swift and consistent restructuring of the financial industry. It has been able to do so through the concentration of supervisory authority and information. Also, with the gathering of comprehensive information about all kinds of financial activities, the inter-linkage and consistency of supervisory activities have increased. On the other hand, the grey areas in supervision, which existed under the multiple-regulatory structure, have been largely eliminated.

However, there is increasing concern that conflicts of interest between the prudential regulations of the supervisory agency and the macro-economic policies of the MOFE might limit the efficient implementation of supervision policies.

The threat of the insolvency of a number of credit card companies has recently become a potential source of risk to the financial market stability. There has been suspicion in some quarters that the reason the FSC was unable to nip the looming insolvency problem in the bud was because of its lax supervision of credit card companies under the influence of the MOFE that wanted to boost domestic demand.

With regard to this problem, the question of an adjustment of the functions of the MOFE, the FSC and the FSS has recently come under discussion.

4. Response of the Bank of Korea to the new financial supervisory system

Now I would like to tell you how the Bank of Korea has come to live with the new financial supervisory system.

As you know, a central bank needs a wide range of up-to-the-minute information on the financial markets not only to carry out monetary policy but also to perform its function as the lender of last resort.

Though stripped of the banking supervisory function, the BOK has been given the statutory right to request managerial information from banks and to ask the FSS to examine banks with it on a joint basis. It can also ask the FSS to examine banks on specific areas of concern to the central bank.

In actual practice, though, the BOK has had considerable difficulty in gathering information. Banks often took a negative attitude toward the BOK's demand for managerial information. Moreover, the BOK has no right to demand information from non-bank financial institutions.

Under these circumstances, the BOK has prevailed upon the FSS to provide it with materials such as the reports filed by financial institutions. This January, the BOK, the FSS, and the KDIC agreed a memorandum of understanding providing for a dramatic increase in information sharing among them.

This means that the central bank is now able to collect managerial information both from banks and non-bank financial institutions.

Another area of concern was the on-site examinations to check banks' managerial status. In its early days, the FSS was reluctant to accept the BOK's requests for bank examination, even though it was legally stipulated that the FSS should accept the BOK's demands for bank examination. In 2002, the FSS went so far as to turn down the BOK's demand for a joint examination. This clash spurred the two organizations to draw up a memorandum of understanding in October 2002 after a hard negotiation. Under it, the FSS must accept the BOK's demand for joint examination provided the MPC decides this necessary.

The arrangements, nonetheless, suffer from the limitation that the Bank has no option but to stick to the FSS's examination schedule. It is still impossible for the BOK to hold an on-site examination when it judges this warranted.

It was a big issue whether to give the BOK the power of independent examination, even at the time of reforming the financial supervisory system in 1997. On that occasion, the BOK took the position that it should be free to examine banks at its own discretion. The National Assembly, however, accepted the government's argument that if the BOK examined banks independently of the FSS, the burden on the financial institutions might be too heavy and that joint examinations should be held with the BOK joining in the FSS's on-site examination.

Under the present joint examination system, the FSS examines general matters regarding financial institutions' managerial soundness. For its part, the BOK examines only limited areas related to monetary policy and the payment and settlement system. The two institutions, meanwhile, pool the information that they gather in the course of on-site examination, and draw on it for their respective operations.

There is one more issue concerning financial stability and efficiency, although it is not directly related to banking supervision. That is the need for strengthening the central bank's oversight of the national payment and settlement system. The case for this is constantly advocated by multilateral financial institutions such as BIS and IMF. In this regard, the BOK was given the authority to oversee the various payment and settlement systems in Korea under the most recent revision of the Bank of Korea Act in September 2003. Under the revised legislation, the BOK may demand relevant materials from both banks and non-bank financial institutions that take part in BOK-Wire, the real time gross settlement system operated by the BOK. It may also request the improvement of payment and settlement systems operated by other entities.

All this means that the BOK has come to play many roles in order to secure financial market stability in spite of its limited official powers of financial supervision.

5. Concluding remarks

Let me now indicate a few points that central bankers may wish to bear in mind from our experience following the integration of financial supervisory agencies in contemplating the reorganization of their own national financial supervisory framework.

Firstly, in the light of other countries' example and Korea's experience, I do not think there is any one-size-fits-all supervisory system that is the optimal for every country. In particular, I think there are various alternative options regarding the issue of the central bank's supervisory function. These will depend on the degree of financial market development and a nation's traditions related to the division of roles between government and central bank. And I think that it rests with the financial system characteristics of a particular country whether it should go for an integrated financial supervisory body or multiple supervisory agencies for the various types of financial institution.

Secondly, it is absolutely essential for central banks to obtain a wide range of information on financial markets and the management status of financial institutions whether or not they are responsible for bank supervision. Where a separate bank supervisory agency exists, a system of co-operation with it must be built up so that necessary information can be collected promptly. It is also desirable for the central bank to have the authority to conduct the on-site examination of financial institutions independently so that it may obtain the necessary information when there is a high degree of market instability.

Thirdly, it is vital to set up a system for policy coordination so that the opinions of the central bank are reflected in the supervisory policies of the financial supervisory agency. Prudential supervision is closely related to monetary policy. If the financial supervisory agency strengthens prudential supervision, this may bring about similar effects to the tightening of monetary policy. Therefore I think it is crucial that the supervisory agency be required to consult with the central bank before the revision of prudential regulations. What is more, the central bank should, where necessary, have the right to ask the supervisory agency to adjust its prudential regulations.

Korea’s current supervisory system was introduced in some haste under the extraordinary situation prevailing in the aftermath of the currency crisis six years ago. Therefore, there have been some frictions between the institutions concerned with financial supervision.

In the course of time, its shortcomings have been made good to a considerable extent, but to my mind a number of areas still call for improvement.

Drawing my remarks to a close, I venture the hope that Korea’s experience may serve as a useful reference for member countries in discussing the reorganization of financial supervisory systems.

Thank you very much for listening so attentively.