A Shift in the Korean Banking and Finance Market

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Introduction

The banking and finance markets in Korea are different from other markets of the Asia-Pacific region, given that the Korean financial market has rapidly grown up in compliance with government open policy after the International Monetary Fund crisis in 1997. In weathering the crisis, the Korean government set up a new unified regulatory institution called the Financial Supervisory Committee to efficiently regulate various financial institutions.

Another specific characteristic of the finance market in Korea is that the volume of on-the-counter derivative transactions is abnormally bigger than that of other financial product transactions.

Given these backgrounds, I would like to briefly introduce the new trends and challenges of the Korean banking and financial markets.

Understanding Banking and Finance in Korea: Trends and Laws

The Introduction of the Capital Market and Financial Investment Act

The Capital Market and Financial Investment Act was newly enacted in Korea in February 2009. This act was enacted to systematically define and regulate various financial products and markets in accordance with growing needs. In the past, there had not been a unified code in Korea to regulate various financial products.

This act covers the business practices of most financial institutions. At first, most financial institutions in Korea were worried about the broad regulations set forth in the new act, since it required higher standards compared to regulations set in other acts, such as the old Securities Exchange Act. For example, the new act requires a higher duty of care, including the duty to explain material facts and a suitability rule when dealing with the financial institution's clients.

I do not think there has been a common standard applicable to various financial product transactions. I believe this amendment of the new act is the most important step to being in accordance with the Securities Act of 1933 and the Securities Exchange Act of 1934 in the United States.

This is one of the most peculiar steps among the Asia-Pacific regions, because the new act incorporates most financial institutions and financial products, such as cutting-edge derivative products. The Bank Act additionally regulates commercial banks and sets forth governance and internal control requirements that are specific to commercial banks.

Trends Affecting Korean Banks

One of the most important trends involving banking and finance in major banks in Korea has been to incorporate a financial institution's work within the bank's work. Most major banks in Korea have been trying to expand their business areas toward insurance, fund, and derivative products. Recently in Korea, most large-scale banks have changed their corporate governance form into a holding company structure, keeping with this trend.

Bancassurance is one of the major deregulations that is beneficial or detrimental to insurance companies. Bancassurance means a business structure in which banks make up new insurance products and sell them to clients with the aid of insurance companies. At first, insurance companies can cut down the selling cost by using the bank's office as another selling point. However, as time goes by, banks start to set up new insurance companies under the umbrella of the holding company system, which can affect the old insurance companies' benefit structure.

This year the regulatory authorities in Korea reported that the government would introduce a bank tax. This bank tax states that any commercial banks borrowing from foreign countries are taxable in order to keep sustainable leverage, in accordance with the trend set by developed countries after the global financial crisis in 2008. I think it is one of the steps toward a new financial regulatory framework.

These trends are important because until recently Korean banks provided liquidities to families who wanted to buy houses in accordance with the housing boom in the world. After the Lehmann crisis, the regulatory authorities worried about household debts in spite of the strict loan-to-value ratio and debt-to-income regulation—different from the US mortgage system—provided by the Korean government. Banks are trying to borrow money from foreign banks to provide liquidity to the household market, and that is one of the major reasons for the introduction of the bank tax.

The mortgage system differs between the United States and Korea, because the ratio of down payment to purchase price is over 40 to 60 percent in Korea compared to just 10 to 20 percent in the United States. The regulatory authorities expect that the housing crisis will not occur in Korea considering loan-to-value and debt-to-income regulation, but household debts are still in the focus of the government policy.

Furthermore, the strict regulation of savings banks is at the center of the controversy in the Korean financial market, because most savings banks have many project financing loans, which would likely become bad loans. Recently a few savings banks in Korea have been sanctioned by the Financial Supervisory Committee for not meeting the level of capital and liquidity standard set forth in the relevant rules. It has triggered the necessity to strictly regulate internal control or compliance systems in savings banks.

In response to these trends, many major law firms in Korea are expected to structure a task force to provide legal advice concerning the savings bank regulation recently raised by the Financial Supervisory Committee. In the past, there have been a few cases concerning legality of sanctions on the savings bank, and I provided legal advice to the Financial Supervisory Committee.

Analyzing Recent Litigation

The ELS Manipulation Case

One finance case I think other lawyers may need to be aware of is a recent equity linked securities (ELS) manipulation case (Seoul High Court 2010na71761). This case is currently at the center of the controversy in Korea. The key issue is whether the securities company had the intention of manipulating the underlying asset's price to prevent the early redemption condition that is beneficial to the clients.

The Korea Stock Exchange issued a report that a few securities companies had the intention of manipulating the underlying asset's price to prevent the early redemption condition. After the issuance of the Korea Stock Exchange, a few ELS investors filed a lawsuit against the ELS-issuing companies, arguing that they had the manipulation intent. The securities companies argued that they just followed the delta hedge strategy set forth in the Black-Scholes model and therefore did not have the manipulation intent.

Among many professionals, it is still in the center of controversy whether the ELS-issuing companies have the manipulation intent, notwithstanding the fact that they mechanically followed the delta hedge strategy that is generally accepted.

The KIKO Case

Another major case is that of knock-in knock-out (KIKO) products (Seoul Central District Court, 2008gahap114545). KIKO is one of the hedge products structured to hedge the risk in relation to exchange rate volatility. Many small or medium companies transacted with banks that sold the KIKO product—a foreign exchange hedge product, not a future exchange product—which is beneficial to the buying companies provided that the foreign exchange rate only changes between limited ranges. If the foreign exchange rate skyrockets, the buying companies are exposed to significant risk. Thereafter the companies brought many lawsuits to invalidate the contract and prevent the effects of the knock-in condition.

During litigation, the major argument on the plaintiff's side was the lack of sufficient explanation of the structure and the risk of the products. The duty to explain material fact requires financial institutions to provide material facts concerning product structure and risk of financial products. In the case of violation of this duty, the financial institution may have the liability to indemnify the customer's loss.

The other major argument was the violation of the suitability rule. The suitability rule requires financial institutions to know their customers' needs and to suggest suitable products, and it is accepted by the Korean Supreme Court as one of the duties of care in dealing with financial products. In the case of violation of the suitability rule, the financial institution may have the liability to indemnify the customer's loss.

The above duties (the duty to explain material facts and the suitability rule) were not clearly incorporated in the old act. However, the Korean court implicitly adopted it from the 1990s. These two arguments raised by the plaintiffs' side are based on the Capital Market and Financial Investment Act. This act explicitly set forth the duties of financial institutions, including the duty of explanation and the suitability rule.

On the side of the defendant, one of the major arguments is that the KIKO product is fairly structured and the plaintiffs are sophisticated investors who sufficiently know the structure and risk of the product.

Litigation's Impact on Clients and Lawyers

Recent litigation regarding ELS and KIKO products has affected many financial institutions in Korea. Some have sold the ELS product, and some products are privately structured while others are structured by the foreign investment banks. I would guess that more than 50 percent of financial clients in Korea currently face this challenge, which might be raised if a customer believes the financial institutions have the manipulation intent and in fact manipulated an underlying asset's price to prevent the early redemption condition.

Lawyers are generally not accustomed to cutting-edge derivative products. Therefore, it is important to set forth the structure of the new financial product to prove that the product is fairly structured as opposed to the plaintiff's argument.

The Effects of the Economic Downturn

The economic crisis in 2008 has resulted in major lawsuits, including the KIKO and ELS cases. Many small and medium companies have been affected by this crisis, especially those that transact with foreign companies. Financial institutions that structured or sold products to clients have also been facing a higher duty of care standard.

Globalization and the Banking and Finance Market

I think globalization has affected banking and finance in Korea. In fact, the financial investment sector is one of the most globalized sectors in the

country. Globalization generally requires a higher standard duty of care on the financial institution's side. Globalization and the resulting regulation protect the clients of financial institutions by clearly setting forth the duty of care of financial institutions.

Responding to Changing Client Needs

A Shifting Client Base

Until recently, typical clients for my business were securities companies and asset management companies. Since the economic crisis, real estate trust companies and other financial advisory companies have been a growing part of our client base due to the project financing problem prevalent in the Korean construction market.

Until recently, real estate trust companies have been using project financing schemes to gather the large amounts of money that are necessary for large-scale construction projects. But after the global financial crisis, there has been a considerable volume of advice requests from real estate trust companies in connection with project financing dispute issues between financial investors and strategic investors.

Also, financial advisory companies are growing up fast in Korean financial markets in accordance with growing needs concerning asset management.

I think these growing needs from the real estate trust and financial advisory sector would be one of the most important client bases.

The Concerns of Banking and Finance Clients

One of the greatest concerns of banking and finance clients currently is the adoption of bank tax to regulate the debit-credit ratio that is monitored by the Financial Supervisory Committee. It is one step of the new financial regulatory framework. Until the adoption of the bank tax, most banks are free to borrow money from foreign companies in case they need money to provide liquidity to households. However, after the adoption of the bank tax, banks will have to consider the pros and cons of borrowing money from foreign companies.

Another concern is the adoption of a higher standard of the duty of care in dealing with the structuring and selling of financial products. These concerns are mainly due to the revision and amendment of the relevant code involving financial institutions as well as the current economic crisis.

After the enactment of the Capital Market and Financial Investment Act, it is believed that the Korean court requires a higher duty of care than before. Therefore, most financial institutions prepared internal compliance manuals concerning duty of care in order to prevent incomplete selling errors.

This act requires financial institutions to check whether the client is a general investor or a sophisticated investor, and it adds an additional duty not to suggest financial products that are presumed to be improper considering the client's asset or investment purpose. (Capital Market and Financial Investment Act, Section 46) Furthermore, this act requires financial institutions to explain material facts concerning financial products when selling them to general investors. (Capital Market and Financial Investment Act, Section 47)

Changes in the Needs of Clients

Client needs in Korea are increasing because of the new environment after the enactment of the Capital Market and Financial Investment Act. Many clients are asking us to provide them with manuals concerning the duty of care in dealing with their clients.

Given various cutting-edge financial products and various investors' spectrums, it is difficult for the financial institution to explain and check each client's need. Therefore, I think it is necessary as a first step for financial institutions to prepare internal manuals or internal control systems to legally comply with the new regulation.

Best Practices for Client Strategies

Preparing Clients for Entering the Banking and Finance Market

Before entering the banking and finance markets in Korea, clients need to be aware of all the relevant regulations and whether there might be

restrictions that make it difficult to enter the market. The Capital Market and Financial Investment Act and the Bank Act are the most important regulations. Also, the Financial Supervisory Committee has prepared relevant rules that set forth detailed information concerning the above acts. They also need to contact relevant authorities to check the difficulty of market entry. Clients need to check how strict the entering regulations are and what the exact procedure is to gain the license they want.

Clients attempting to enter this market should prepare to complete research on the relevant regulations and contact the regulatory authorities before deciding to enter the market via the advice of the law firms practicing in that area. A law firm that has experience in dealing with high-profile cases can give proper advice.

Meeting with Clients

At initial client meetings, I request a clear footprint of the structure the client is trying to build and the exact intent of the client. Having this information is necessary to appropriately advise clients.

When meeting with clients to build a strategy, the most important thing we cover is any relevant regulations that might affect the issued case. After the enactment of the Capital Market and Financial Investment Act, the research burden has been reduced compared to the old various regulation systems, because this act broadly encompasses unified regulation covering the bank, insurance, and securities areas.

I collect all relevant documents from the client that might be involved in the issued case, including e-mail transmissions or drafts. Although the Korean court does not adopt the discovery system in the United States, sometimes it issues document production orders relevant to the issued case. Therefore it is necessary to check and review in advance all relevant documents.

Partnering with Legal Experts and Government Agencies

When working on banking and finance matters, I usually ask the Financial Supervisory Committee member whether there may be any concern in dealing with the delicate financial matter. Sometimes this method is helpful to the client's need rather than providing simple dry legal advice, because financial clients sometimes need a practical answer rather than a dry legal opinion. To locate the best resources for the client, I usually check the organization's structure and the members, and then I check for someone who may know the relevant members.

The Financial Supervisory Committee is the sole centralized government authority involved in the banking and finance arena in Korea. They regulate the entry market and sanction the financial institutions. I worked with the officials of the Financial Supervisory Committee about five years ago when I was involved in administrative lawsuits in connection with the legality of the sanction against a savings bank. This organization has a typical hierarchical structure, so my advice for communicating with the committee would be to remember you are contacting the responsible officials.

Facing the Obstacles and Challenges of Banking and Finance Matters

Current Obstacles

One of the current obstacles faced by banking and finance clients in Korea is the government's attempt at adopting new regulations, including a bancassurance system. This system would deregulate the banks' work frontier. As in the case of bancassurance, the conflict of interest between banking and financial clients is difficult to resolve.

Navigating Obstacles

One of the most difficult things to navigate when it comes to banking and finance policies in Korea is the volatility of the policies. The intent can change based on the current governing party, and it can therefore be difficult to determine what to expect when it comes to future policies. Major law firms can assist clients on this issue by providing what they believe would be reasonably expected regulations.

Conclusion

Bank regulations, including the bank tax, are currently in effect in pursuit of the regulations enacted in the United States and the European Union. Until the Lehmann crisis, the Korean government was trying to strengthen the

investment banking works in Korean financial institutions. However, after weathering the financial crisis, the Korean government is now trying to adopt the advanced regulation system of the United States. The strict regulation set forth in the Capital Market and Financial Investment Act is regarded as one of the adoptions of the advanced system.

For example, the suitability rule set forth in Section 46, 46-2 of the Capital Market and Financial Investment Act was incorporated after reviewing similar regulations set forth in the Financial Services and Markets Act of the United Kingdom.

The adoption of the strict regulation means that clients need to prepare much more to strictly comply with regulations set forth in the act. After the enactment of the Capital Market and Financial Investment Act, most financial institutions prepared exemplary manuals to be in accordance with the new regulations.

Although the areas covered by the Capital Market and Financial Investment Act are both broad and comprehensive, cutting-edge derivatives and derivative-linked products have been coming up recently. For example, it is not clear whether FX margin transactions and investment deposits are regulated under the new act.

Furthermore, the ELW manipulation issue is currently at the center of regulatory concerns in Korea. Until recently in the ELW market, liquidity providers and scalpers have conspired to unfairly be benefited to the detriment of investors.

Although the banking and financial regulatory system is going to be converted into a unified standard, most Asia-Pacific regions still have specific regulations. Some advice I can provide would be that it is sometimes still necessary to cooperate with domestic law firms to fully understand and prepare the client's needs. It is important to stay up-to-date on the latest issues in this area, and it can be helpful to regularly attend seminars and prepare relevant issues concerning the financial markets. It is also beneficial to cooperate with domestic law firms to prepare for unexpected difficulties in dealing with banking and financial matters.

Key Takeaways

- Be aware of all relevant regulations before entering the banking and finance markets in Korea.
- Assist clients by providing what you believe would be reasonably expected future regulations.
- Cooperate with domestic law firms to prepare for unexpected difficulties in dealing with banking and financial matters.

Related Resources

Cases

- Seoul High Court 2010na71761
- Seoul High Court 2009ra997
- Seoul Central District Court 2009gahap90394
- Seoul Central District Court 2008kahap3816
- Seoul Central District Court 2008gahap114545
- Seoul Central District Court 2008gahap108359, 2009gahap41859

Statues

- The Capital Market and Financial Investment Act
- The Bank Act

Byung-Chang Lee has been a partner with Shin & Kim since 2002, focusing on securities and finance, as well as professional liability disputes. He has also served as a foreign legal consultant for Steptoe & Johnson LLP. He earned his BA in economics from Seoul National University and his LLM from Cornell Law School.

Dedication: *To Sujin, Yoonhoo, and Yoonseo.*