Financial Services Commission

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Press Release

April 8, 2014

FSC PLANS TO OVERHAUL NCR RULES FOR SECURITIES COMPANIES

BACKGROUND

The net capital ratio (NCR) has been serving as a key index to assess financial soundness of securities firms since it was first introduced in April 1997. The NCR has been widely used as standards for financial authorities to take prompt corrective actions, grant membership of KRX, or evaluate primary dealers.

However, it has been pointed out that the current NCR rules no longer reflect changes in securities market and business model. The current NCR rules, mainly focused on regulating brokerage business in domestic market, restrict security firms from engaging in investment banking business or expanding into overseas markets. With the current method of computing NCR, it is difficult to exactly evaluate securities firms' financial soundness or loss absorbing capacity.

Against this backdrop, the FSC plans to overhaul net capital ratio (NCR) rules for securities companies, as part of its efforts to revitalize the country's capital markets.

KEY CONTENTS

1. Modification to the NCR formula

Currently, the NCR is calculated as a percentage of net operating capital to gross risks.

$$\text{Net Capital Ratio (\%)} = \frac{\text{net operating capital[1]}}{\text{gross risks[2]}} \times 100$$

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[1] Balance calculated by subtracting total liabilities from total assets on the statement of financial position as the reference date (net assets) – aggregate of deductions + aggregate of additions (Article 3-11, *Regulation on Financial Investment Business*)

[2] Aggregate of the amounts of market, credit and operational risks (Article 3-11, *Regulation on Financial Investment Business*): (1) 'market risk' means potential losses that a financial investment business entity may sustain as a consequence of market price fluctuation of marketable securities or similar, such as fluctuation of stock prices, interest rates, and foreign exchange rates; (2) 'credit risk' means potential losses that may be sustained as a consequence of a counterparty's non-performance of a contract; and (3) 'operational risk' means potential losses that may be sustained as a consequence of improper or wrong internal process, poor management of human resources or systems, or an external cause or event (Article 3-6, *Regulation on Financial Investment Business*)

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Under the current formula, however, securities firms are forced to hold unnecessarily excessive capital. Securities companies are needed to secure an additional amount of net operating capital, bigger than the increased amount of risks, to maintain the same level of NCR.[3] The current NCR makes investors difficult to figure out amounts of net equity capital of securities firms, leading them to the misperception that higher NCR means the better financial soundness.

The FSC plans to modify the NCR formula as follows:

$$\frac{\text{net operating capital} - \text{gross risks}}{\text{sum of equity capital required to maintain each business unit's license}^{4}}$$

Thresholds for corrective actions will be adjusted to corresponding to the modification to the NCR formula.

	Recommendation of Improvement of Business Management	Demand for Improvement of Business Management	Order for Improvement of Business Management
Current	NCR is less than 150%	NCR falls below 120%	NCR falls below 100%[5]
Revised	NCR is less than 100%[6]	NCR falls below 50%	NCR falls below 0%

Securities companies will be allowed to choose which formula they would use until the end of 2015. The new NCR formula will be fully introduced starting from 2016.

2. Consolidated computations of NCR

Since net capital ratio of a brokerage company is computed on an individual basis, equity investment in its subsidiaries are all subtracted from net operating capital, which fails to properly reflect subsidiaries' risks in the parent company's NCR.
It also restricts securities firms from expanding into overseas market and pursuing M&A since equity investment into such activities are subtracted from net operating capital.

The FSC will introduce consolidated computations of NCR for all securities firms with subsidiaries under the K-IFRS starting from 2016. Prior to the full implementation in 2016,[7] the consolidated NCR rule will be first applied to large securities companies[8] in 2015 as a pilot operation.

[3] If a brokerage firm's risks, for example, increase by KRW 100 million, the firm needs to secure KRW 500 million worth of additional capital in order to maintain the industry's average NCR of 479%.
[4] 70% of sum of minimum equity capital for each authorized business unit
[5] net operating capital = gross risks
[6] net operating capital – gross risks = sum of equity capital required to maintain business license
[7] Implementation schedule can be adjusted, if necessary, depending on the industry's preparations to adopt the new rule during the period of the pilot operation.
[8] Securities firms with equity capital more than KRW 1 trillion

3. Adjustment of items subtracted from net operating capital

Securities firms' loans to companies are currently subtracted from net operating capital, which drives NCR down. That has been constraining securities firms' investment banking (IB) business. In order to address such problems, securities firms' corporate loans will be reflected into credit risks, instead of being subtracted from net operating capital.

SCHEDULE

Considering the impact of new NCR rules on the industry, modification to the NCR formula and consolidated computations will be implemented after the FSC gathers opinions from the industry through public hearings and then revise relevant regulations.

Adjustment of items subtracted from net operating capital will be implemented as soon as relevant regulations are revised (presumably in the third quarter of 2014).

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For any inquiry, please contact Foreign Press & Relations Team at fsc_media@korea.kr

<u>APPENDIX</u>

<Net Capital Ratio of Financial Institutions (as of end-2013)>

(KRW billion)

	Equity Capital	Net Operating Capital	Gross Risks	NCR(%)	Number of Companies
Large Financial Institutions	24,407.0	17,337.5	3,644.4	476	9
Medium Financial Institutions	13,334.1	10,548.3	2,279.4	459	24
Small Financial Institutions	3,023.5	2,498.3	416.8	614	27
Impaired Capital	644.9	586.3	695.0	844	9
Unimpaired Capital	40,119.7	29,797.8	6,271.1	475	51
Total	**40,764.6**	**30,384.1**	**6,340.6**	**479**	**60**

* Large financial institutions: equity capital equal to or larger than KRW 1 trillion
Medium financial institutions: equity capital equal to or larger than KRW 300 billion
Small financial institutions: equity capital less than KRW 300 billion