

PLANS TO IMPROVE RULES ON STRUCTURED PRODUCTS

The FSC announced its plans to improve rules on retail structured products¹ on July 30, with an aim to strengthen securities firms' preparedness for market volatility, to encourage reduction in the size of the issuance as well as diversified investment for hedge assets and to bolster investor protection measures.

BACKGROUND

The market for retail structured products has grown significantly as the continuing trend of low interest rates made them an attractive alternative to bank savings. Although the structured products have provided relatively high yields and helped individuals to expand their assets, various risk factors began to surface. For securities firms, large volume of structured product issuance and management pose significant burdens on their financial soundness and liquidity. These burdens also may create shocks in the foreign exchange market and short-term money markets. In addition, both distributors and investors often espouse misperception that structured products are safe and non-risky products even though market volatility may rise depending on the performance of underlying assets. Therefore, it is necessary to draw up measures that will help minimize risks to securities firms, financial markets and investors.

OVERVIEW OF STRUCTURED PRODUCTS

(BALANCE) The outstanding balance of ELS, ELB, DLS and DLB issuance² surged from about KRW22 trillion in 2010 to KRW108.6 trillion at the end of April 2020, maintaining an above KRW100 trillion level since 2016. About 60 percent of them are non-principal-protected structured products (ELS and DLS), accounting for KRW64.6 trillion. ELS and ELB (tracking stock indexes) account for 70 percent, or KRW75 trillion.

(DISTRIBUTION) For ELS investment, retail investors made up about 98 percent, or KRW40.4 trillion at the end of March 2020. About 82 percent of all ELS issuance, or 88 percent of ELS issued to retail investors were distributed through banks.

(RISK FOR SECURITIES FIRMS) Structured products make up increasingly larger proportions in relation to the securities firms' total assets, which raises concerns about their soundness and liquidity.

¹ Including equity-linked securities, derivative-linked securities, equity-linked warrants, exchange-traded notes, equity-linked bonds, derivative-linked bonds

² ETNs and ELWs are excluded as they are exchange-traded derivatives with a specific set of investor protection measures in place.

<Ratio of Structured Products to Total Assets for 21 Securities Firms>

(In trillion KRW, %)

	End of 2010	End of 2012	End of 2014	End of 2016	End of 2018	End of 2019	Compared to End of 2010
Structured products (A)	22.4	51.6	84.2	101.3	111.7	108.4	+83.6
Total assets (B)	160.0	211.4	267.8	335.3	413.6	455.5	+376.7
(A/B)	14.0	24.4	31.4	30.2	27.0	23.8	+9.8%p

Overseas traded derivatives products that are essential to the management of ELS and DLS hedging can pose risks to domestic financial markets as they can spread global market shocks to domestic markets.

When the value of underlying assets based in overseas markets drops abruptly, securities firms turn to short-term money markets and to foreign exchange market to answer margin calls. This may spread shocks and risks to short-term money markets and foreign exchange market.

(RISK TO INVESTORS) Although structured products provided an alternative to high-yield savings accounts, there remain risks of misselling for investors as there are misperceptions about their profitability. Retail investors face early redemption fees and are often unaware of the complexity of the structure of the products and their underlying assets when making investment decisions. With rising market volatility, ELS coupon yield has also increased. As such, there are concerns over misselling as more investors are hunting for yield.

KEY MEASURES

I. IMPROVE SOUNDNESS AND LIQUIDITY RULES ON SECURITIES FIRMS

(BOLSTER INTERNAL RISK MANAGEMENT) Require securities firms (a) to conduct stress tests reflecting more extreme case scenarios (e.g. 5%~50% drop in underlying asset value) and (b) to prepare contingency plans to bolster their foreign currency reserves for ELS hedging

Revisions to relevant regulations are necessary.

(IMPROVE LIQUIDITY RATIO RULES) Strengthen regulations on currency liquidity ratio for all securities firms issuing structured products by (a) calculating their current liabilities from the time of early redemption instead of the time of final maturity and (b) applying the same currency liquidity ratio rules to securities firms as they are applied to the financial investment companies

Revisions to relevant rules and regulations are necessary. Revisions will be applied to newly issued structured products.

II. PREVENT SPREAD OF SYSTEMIC RISKS

(STRENGTHEN LEVERAGE RATIO RULES) Prevent excessive issuance of structured products by expanding the weight of debt on leverage ratio for higher volume of structured product issuance in excess of 50 percent of equity capital

Place more weights for more issuance of ELS and DLS in relation to the firm's equity capital as shown in the table below from the ELS and DLS balance of about 50 percent of the equity capital to more than 200 percent

Ratio of equity capital to total ELS & DLS issuance	Debt weight in leverage ratio	
	From 2022	Until end of 2021
50% or below	100%	100%
51% ~ 100%	125%	113%
101% ~ 150%	150%	125%
151% ~ 200%	175%	138%
201% ~	200%	150%

Exemptions to these rules will be applied to ELS and DLS products with underlying assets based in domestic markets and thus have limited possibility for investor damage or impact on the foreign exchange market.

Revisions to relevant regulations are necessary. Revisions will be applied to newly issued structured products.

(INTRODUCE RULES TO DIVERSIFY HEDGE ASSETS) Establish rules on diversifying hedge assets to help resolve the problem of currency mismatch between underlying assets and hedging assets and that of concentration toward debt issued by credit finance businesses

- a) Require a certain level (10%~20%) of liquid asset holdings in foreign currency for ELS hedging that tracks underlying assets in foreign markets
- b) Set a limit to incorporating debt issued by credit finance businesses to up to 10 percent of the total hedge assets

Revisions to relevant rules and regulations are necessary. Revisions will be applied ex post facto but in gradual steps given the possibility of market volatility.

III. STRENGTHEN INVESTOR PROTECTION

(SET UP INTEGRATED INFORMATION PLATFORM) (a) Establish an integrated information platform to provide relevant information on structured products, including ELS, DLS, ETN, ELW, ELB and DLB, offering information about product details, underlying assets, yield and loss conditions, risk rating, etc., and (b) establish an exchange-based platform through which investors are able to sell structured products prior to their maturity

By establishing an objective pricing system, investors will be able to check up-to-date value of their investment products on the integrated information platform. Investment products will be reorganized into different categories by their characteristics and risk weights to help improve investors' understanding.

The government plans to set up necessary infrastructure for the platform by the end of 2021.

(IMPROVE OBJECTIVITY IN PROVIDING PRE-SUBSCRIPTION INFORMATION) Require more balanced way of providing information about the yield and loss conditions prior to subscription

Relevant guidelines will be provided through the Korea Financial Investment Association.

Along with the above mentioned measures, the government will work to ensure that the previously announced investor protection measures concerning high-risk investment products³ are effectively implemented beginning in the second half of this year.

SCHEDULE

The FSC will promptly carry out revisions to the regulations as there are possibilities of increasing volatility in financial markets. The revisions requiring no changes in regulations will be implemented immediately through administrative guidance in August.

The FSC will work to complete regulatory revisions within this year, although actual application of certain revisions may be postponed considering their expected effects on market conditions.

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For press inquiry, please contact Foreign Media Relations Team at fsc_media@korea.kr.

³ Please click [here](#) to view the press release dated December 12, 2019.