Financial Services Commission

# Press Release

July 26, 2022

## FSC ANNOUNCES PLAN TO INTRODUCE INSOLVENCY RESOLUTION MECHANISM FOR FINANCIAL INSTITUTIONS

The FSC announced a plan to introduce an insolvency resolution mechanism for financial institutions (tentatively called “financial stability account”) to help prevent insolvency of financial institutions. The plan was discussed at the financial risk response taskforce meeting held on July 26.[1]

With changes in financial market environment, there have been calls for introducing a mechanism that can help protect financial institutions against insolvency and prevent risks from spreading in advance. In the wake of the 2008 global financial crisis, major economies such as the U.S., EU and Japan established such preventive support systems. In this regard, the FSC is considering ways to introduce an insolvency resolution mechanism for financial institutions (tentatively called “financial stability account”)[2] for insolvency prevention of financial institutions through liquidity provision and capital expansion. The FSC will prepare a detailed plan after coordinating with relevant ministries and institutions and gathering opinions from experts and seek revision to the Depositor Protection Act accordingly.

### BACKGROUND

With some of the changes taking place in the financial industry such as the growth of the nonbank sector, deepening interconnectedness between financial sectors and unpredictability in shock originating from the real economy sector, there is growing concern about risks in certain areas spreading across the entire financial system. Therefore, through provision of liquidity injection and capital expansion to the financial sector facing temporary distress amid a crisis situation, it is necessary to keep the cost of maintaining stability in the financial system to a minimum level[3] by preventing insolvency of financial institutions as well as spread of risks.

<Cases Requiring Liquidity Provision and Capital Expansion in Financial Sectors>

a) **(TEMPORARY LIQUIDITY CRUNCH)** Securities firms facing liquidity shortage due to a slide in stock prices in March 2020 sought to bolster their KRW and FX reserves, which resulted in interest rate hikes for corporate bonds issued by specialized credit finance companies and increased costs for many insurers’ currency hedging for foreign investment purpose.

b) **(DECLINING CAPITAL CAPACITY ACROSS SECTOR)** There are concerns about abrupt deterioration in insurers’ risk based capital (RBC) ratio due to changes in interest rates, international standards, etc.

1 This is a follow-up to seeking ways to provide funding support to preemptively deal with the insolvency risk of financial institutions amid rising volatility in financial markets, which was discussed at the last taskforce meeting held on June 23, 2022.

2 A separate account to be established within the deposit insurance fund to be operated with guarantee fees, borrowing from other accounts and bond issuance without imposing burden to fiscal expenditure.

3 The current depositor insurance fund provides funding support to insolvent (or at risk) financial institutions ex post factor, so there are concerns for bigger costs when insolvency spreads.

Major economies such as the U.S., Japan and EU had already set up relevant systems to prevent systemic risks and minimize the cost of insolvency resolution in the wake of the 2008 global financial crisis. On the contrary, the crisis response mechanisms in Korea such as the depositor insurance fund support and setting up public funds focus on ex post facto stability management after insolvency takes place. Thus, the authorities will upgrade the measures[4] that had been introduced in the past to make proactive and preventive support system available on a permanent basis and utilize them in complement with other financial stability tools available.

## DETAILS OF THE PLAN

<Key Direction of the Plan>

a) **(PURPOSE)** Make proactive and preventive funding support system available for financial institutions on a permanent basis to protect financial institutions against insolvency and prevent risk contagion in order to maintain stability in financial markets and the system

b) **(OPERATION)** Based on the principle of "beneficiary's liability" and "collection of total funding input," the insolvency resolution mechanism will be operated without imposing burden on government budget.*

* Minimizing burden on the public by excluding government investment or government-sponsored bond issuance from financing methods

c) **(MANAGEMENT)** Design eligibility and application procedures reasonably to enable financial institutions to actually make use of the system and establish a mechanism to prevent moral hazard in financial institutions

### I. CONDITION AND ELIGIBILITY FOR IMPLEMENTATION

Implementation of the insolvency resolution mechanism will apply to financial institutions facing temporary distress (not an insolvent or at-risk financial institution)[5] when the FSC considers the situation[6] to be alarming for financial markets and the system. In the process of deciding whether to implement the insolvency resolution mechanism, the FSC will consult with relevant ministries (Ministry of Economy and Finance) and institutions (Bank of Korea and Financial Supervisory Service) to gather opinions and seek coordination with other policy goals and mechanisms.

### II. TYPES OF FUNDING SUPPORT

Depending on how the crisis situation unfolds, the insolvency resolution mechanism will provide support in the form of either liquidity provision (debt guarantee or loan) or capital expansion (preferred stock purchase) and collect funds within the agreed upon time frame.

**(LIQUIDITY PROVISION)** Provide guarantees (e.g. 3-year or less) for bonds issued by financial companies and collect guarantee fees from financial companies participating

[4] The support programs such as banks' capital expansion fund, financial stabilization fund and special loan for financial stability expired without much outcome since these programs take long time to prepare for operation, have strict application requirements, limited eligibility and were operated on a temporary basis.

[5] Support for insolvent (or at-risk) financial institutions is currently available through the depositor insurance fund (Article 38, Depositor Protection Act)

[6] e.g. (a) Due to abrupt changes in financial markets or system, (b) when many financial companies face liquidity crunch or are in need of capital expansion and (c) thus requiring a prevention of confusion in financial markets or system.

- Use loan as a supplemental tool when it is difficult for financial companies to issue and distribute bonds[7]

**(Capital Expansion)** Purchase preferred stocks[8] issued by financial companies and collect funds in the form of dividend and preferred stock payments from financial companies

## III. Financing Mechanisms and Operation

Within the deposit insurance fund, a separate account (tentatively called "financial stability account") will be established for the operation of the insolvency resolution mechanism, and government investment or issuing government-sponsored bonds will be excluded from financing methods.

**(Liquidity Provision)** To be operated with revenue from guarantee fees (debt guarantees require no upfront financial resources)

- In the event of a guarantee accident, payments will be made from fee revenues or through borrowing from other accounts and collect funds thereafter from the financial company

**(Capital Expansion)** Provide funding support[9] through Korea Deposit Insurance Corporation's bond issuance or borrowing from other accounts and collect funds through preferred stock payments from financial companies

## IV. Procedure

Program implementation decision (by FSC in coordination with MOEF, BOK and FSS) → Application and registration by financial company (KDIC) → Application review and determination of the size of funding support (Deposit Insurance Committee) → Report to FSC → Program implementation begins (provision of funding support and post-management)

Funding support will be made available for the resolution of distress in areas where a financial company is not capable of handling on its own while taking into account its potential to improve liquidity and capital adequacy on its own during the review process.

## V. Post-management

When providing funding support, financial companies will need to submit a plan for

[7] e.g. Corporate bond issuance limit, bond market freeze, etc. → offer loans depending on market situation (e.g. 1-year or less)
[8] Authorities will decide the conditions for providing support such as the type of stocks eligible for purchase after considering the size of the financial company, effects on financial markets and the real economy, etc.
[9] In the event of a real crisis situation, authorities will decide specific financing methods and the scale after considering the size of specific sector's fund reserve in the depositor insurance fund as well as the amount of financing needed.

improving the soundness of business management[10] and their compliance status will be scrutinized regularly (on a semi-annual basis). If necessary, funding support will be provided with certain conditions attached such as limitations on stock repurchase, dividends and bonus payouts to board members, etc (include in terms of agreement). Certain penalties may be imposed for non-compliance with the management improvement plan such as a raise in guarantee fee, corrective order, sanctions on employees, etc.

## FURTHER PLAN

Authorities will consider holding a seminar or public hearing in August with experts from the National Assembly, academia and financial sectors participating. Authorities also plan to put up for notification a revision proposal for the Depositor Protection Act in August.

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

[10] Amount of funding support and its purpose, self-rescue plan to improve own financial conditions, etc.