FSS Governor Choe Heungsik's Address at the AMCHAM KOREA Capital Markets & Financial Services Committee Meeting

The following is the text of the address that Governor Choe Heungsik delivered at the AMCHAM Capital Markets & Financial Services Committee Meeting on February 8, 2018.

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Ladies and gentlemen, it's great to be with you today. Let me first thank AMCHAM Korea, together with Chairman Jeffrey Jones, and Capital Markets and Financial Services Committee Co-Chairs Joan Chang and Simon Hurst for inviting me and giving me the privilege to speak to such a special audience this afternoon. I also thank AMCHAM members for taking the trouble to be here on such a cold day.

As we all know, AMCHAM Korea has served as a bridge for trade and investment between Korea and the U.S. since its creation in 1953. Over the years, trade and investment between the two countries have been expanding on a foundation of unshakable alliance.

Bilateral trade and investment in financial services have also been strong. Since Bank of America first came to Korea in 1967, the number of U.S. financial firms has steadily grown and is now 36, more than all the other countries. Korean financial companies are also expanding their presence in the U.S. Woori Bank first opened its New York branch in 1976, and since then the number of Korean financial firms in the U.S. has grown to 55.

Needless to say, AMCHAM Korea deserves much credit for the remarkable transformation of commercial relations between the two countries over the years. And you really have much to celebrate when it comes to AMCHAM's success in Korea.

You know, I read somewhere this morning that the U.S. NASDAQ market began trading 47 years ago today. It's an interesting coincidence to note, especially because I am fond of things that last and pass the test of time. I think you will agree that AMCHAM Korea has passed the test of time in Korea as well. And I have no doubt that everyone in this room will continue to work for even more productive partnership into the future.

Ladies and gentlemen,

A number of risks ranging from large to small in magnitude persist in Korea's financial markets. Let's take a quick look at them.

The first is an increasingly uncertain outlook for financial markets. The prospect of major market corrections following significant share price gains and rising interest rates is pointing to potential asset deflation.

The second is household debt and its potential risk to macroprudential soundness. Now, it is true that the overall growth of household debt did slow last year. However, because household debt relative to disposable income remains high, the debt-servicing burden remains high as well, especially on low-income families.

The third is the risk of poorly performing industries triggering a surge in non-performing loans. I note that, with rising interest rates and concerns over protectionist trade policies, the business environment for some companies may not be so favorable. In particular, shipbuilding and shipping continue to suffer from excess capacity, as you know. The outlook for the construction sector is not so favorable either.

The fourth risk I would cite is the heightened potential for declining safety and soundness conditions of financial firms. For instance, we can see sharply rising interest rates setting off steep valuation losses on financial firms' bond portfolio. Or, if the real estate market starts to shift in the wrong direction, we may well see real estate funds and investments suffer major losses.

There is now growing confidence that the much-awaited recovery of the global economy is finally under way. As growth resumes in both emerging and developed economies, the IMF and the OECD are making more optimistic forecasts. The same is true for the Korean economy as well. So we have reasons to be more upbeat and optimistic about the economy's growth prospects.
On the other hand, we continue to grapple with several major potential risks in the financial sector. Let me quickly go through some of them.

The first is household debt and its potential risk to macroprudential soundness. Now, it is true that the overall growth of household debt did slow last year. However, because household debt relative to disposable income remains high, the debt-servicing burden remains high as well, especially on low-income families.

The second is the risk of poorly performing industries triggering a surge in non-performing loans. I note that, with rising interest rates and concerns over protectionist trade policies, the business environment for some companies may not be so favorable. In particular, shipbuilding and shipping continue to suffer from excess capacity, as you know. The outlook for the construction sector is not so favorable either.

The third risk I would note is growing financial market uncertainty. Lately, the Korean won has been gaining against the dollar, and market interest rates are broadly rising. These developments could mean worsening foreign-currency borrowing conditions for domestic financial firms or gradual reversal of foreign capital.

As markets continue to evolve, we see a growing need for a more effective role of finance in the market. As we all know, the essential function of finance is to facilitate economic activity through financial intermediation and to spread the benefits around. In times of prolonged sluggish growth and an aging population, we should expect no less. In addition to intermediation, we would like to see our finance facilitate innovation and growth and help accumulate widely shared wealth.

Unfortunately, what we frequently observe in our financial industry is a defensive, risk-averse culture. More specifically, it is a business culture that encourages short-term rewards, unhealthy competition, and herd mentality and behavior.

One illustration of this is the fact that many lenders demand extra collateral from a borrower even when 80% of the loan is covered by a public guaranty provider. Another is a survey that found Korea's venture capital investment relative to the GDP was 0.13 percent, well below 0.33 percent for the U.S. What the 0.13 percent figure highlights for us is the relatively small contribution of finance to innovation and growth. Moreover, as a result of financial firms focusing on short-term gains, unfair anti-consumer practices persist, and consumer protection often takes a back seat.

Let me now turn to our financial supervision agenda. This year, we intend to deal with household debt and other risks we face in a consistent, systematic manner. We also intend to direct our focus on consumer protection and supervision policies in support of innovation and growth.

I think we can divide our supervision agenda this year into four broad areas. They are consumer protection, improving the stability of the financial system, maintaining orderly and disciplined markets, and innovation and growth through financial reform. Let me quickly go through each.

The first is consumer protection, and we are putting it at the top of our supervision agenda. I understand that, in the past, we were often reactive, not proactive, and moved on after giving relief to consumers who were harmed by financial firms. Going forward, I want to make sure we allocate enough resources to prevention as well.

As we all know, prevention is always better than cure. First and foremost, we are going to work even more than before to put an end to financial firms' misconduct, the primary source of consumer harm and dissatisfaction. Recently, we carried out reorganization at the FSS with an emphasis on supervision of financial firms' conduct in the marketplace. Our reorganization is complete, and we now fully expect to carry out strong conduct supervision this year and in the years to come.

As we do so, I would like to see financial firms do their part by cultivating a healthy pro-consumer business culture. One good step for this would be to establish a set of pro-consumer business principles that put consumers above all else. And when financial firms embrace such "consumer-first" principles into their product development or internal controls, consumers will surely respond and reward those companies.

I also think there are lessons we can learn from behavioral economics that are relevant to consumer protection. I say this because we now understand that consumer behavior is often shaped by our individual bias and prejudice. One inference from this is that consumers do not always make use of information available to them.

So, as we work to improve consumer protection, I think it pays to try to gain a better grasp of consumer behavior. This will surely help us better inform and educate consumers while discouraging financial firms from taking advantage of consumer bias and prejudice.

Our second agenda is continually improving the stability of the financial system. As you know, we are grappling with household debt and a few other macroprudential challenges. What I would like to stress today is that we are going to assume the role of "forward-looking risk supervisor." And we are going to take firm, systematic approaches to the challenges we face.

One example of this I can tell you is the top-down stress test models we developed late last year. So, starting this year, we intend to utilize it extensively to evaluate risk both at the individual firm level and the financial sector as a whole. And where we identify risk to financial stability, we will make sure we respond with proper preemptive measures. With respect to our on- and off-site supervision, we are going to focus our supervisory resources on areas of weakness and perform thorough risk analysis.

The third agenda I want to tell you is maintaining orderly and disciplined markets. Let me give you an example of what I mean by this. During the presidential election last year, we identified a total of 147 so-called "politically themed" stocks. And, as you know, many of them displayed extreme price volatility as the Election Day neared. Even worse, the prices of 33 of these stocks were found to be swayed by market manipulation and other illegal acts. Not surprisingly, it was the ordinary investors who suffered most losses as a result. This year, we have local elections coming up in June. And, already, we have seen the prices of virtual currencies reach levels that are simply well beyond most people's comprehension. These are obvious causes for concern.

So we are going to take a firm stance and make it our mission to go after anything and everything that is illegal. This includes unfair stock trading, accounting fraud, illegal foreign currency buying and selling, and insurance fraud. I want to add that, as before, we are aggressively going after voice phishing, abusive moneylenders, and investment scams.

The last agenda I want to note today is the need to fully restore financial intermediation in support of innovation and growth. As we all know, real economic activities grow when credit flows where it is needed at the right time. All too often, however, this is not what we always observe in the marketplace. This is in part due to financial firms' preference for short-term gains and risk avoidance.

One inevitable consequence of this is that financial firms end up under-performing some of the most basic functions of finance. I believe we have to work to fix the culture of quick reward and risk avoidance because of its ramifications for financial intermediation and market growth.

To be sure, I also see a need to improve our sometimes bureaucratic, heavy-handed supervision practice. In fact, many blame this for financial firms' passive, defensive, and risk-avoiding behavior. So we are going to take a close look at it and fix it in any way we can.

All in all, I think there are some important questions to ask here. One question is whether financial firms' quest for short-term gains distorts their incentives. This question matters because such short-sightedness often creates conditions for unhealthy competition and herd behavior.

Let me now say a few words about rule violation and misconduct by financial firm employees. We understand that we can worsen financial firms' aversion to risk when we punish only individual financial firm employees for misconduct or wrongdoing. So we are going to take more systematic approaches to address the underlying causes and help prevent employee wrongdoing and raise compliance. Similarly, we are going to work to simplify and streamline regulatory processes including licensing and consumer contract review to help reduce financial firms' compliance burden. Let me add that we are taking an adversarial approach for our deliberation of sanctions on financial firms so that they do get a chance to challenge and respond to our findings.

Ladies and gentlemen,

In closing, I would like to share with you some thoughts that came to me over the past five months or so after I joined the FSS. I came to think of three disciplines that the market needs in order to function as it should. They are regulatory discipline, self-discipline, and market discipline.

Of the three, what I have observed so far from the FSS is that regulatory discipline plays an outsize role, much more than the other two. Some might say that this is to be expected given the inherent information asymmetry between consumers and financial service providers in the marketplace. The argument is that regulatory discipline is needed to keep the asymmetry in check.

But one unfortunate consequence of this, as you can imagine, is that financial firms become more defensive and risk-averse over time. So I believe we must work to restore the balance with more effective, more market-friendly approaches.

Let me make some suggestions on how we can start to achieve this. First, financial firms must do more to improve internal controls and manage risk. They must continually evaluate their action from consumers' perspectives and work to serve them, not the other way around. They must also be able to look past their short-term incentives and set their sights on lasting, sustainable goals. I believe this is the right path to take not only for their own good, but also for the good of all.

You know, we have an old saying in Korea that, "No matter how smart you are, you can never outsmart the wisdom of two people." As we work to restore people's trust in our financial system, neither regulators nor financial firms can do this alone. So when regulators put forth an effort to bring about a positive change, financial firms should respond to it with a sense of shared responsibility for the good of all.

The very same of course holds true for foreign financial firms in Korea. I understand circumstances and constraints vary among foreign financial firms. But my hope is that they come to appreciate our emphasis on greater self-discipline and re-commit themselves to it for the good of all.

If there are ideas you wish to propose or share with us for our supervision agenda, you should feel absolutely free to do so. After all, foreign financial firms have much to offer with their unique experience and expertise here in Korea and elsewhere. On behalf of the FSS, I also pledge that I will listen and be responsive to what you have to say. And we will continue to work to create a positive regulatory and supervisory environment for you. So, from global regulatory standards to your compliance cost to our dialogue with the market, we are going to aim for the very best financial supervision.

Let me now close with my best wishes for your continued success in Korea. AMCHAM Korea has a strong track record on promoting U.S.-Korea trade and investment. Korea's financial services industry has benefited as well over the years from the positive trade and investment climate that AMCHAM Korea has long worked to cultivate. So this is one more reason to celebrate AMCHAM Korea and its members today. I very much appreciate the opportunity to speak to you.

Thank you.

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