SESSION 6

Korea's Experience: Crisis Preparedness and Crisis Simulation Exercise (CSE)

Discussion Material for IFIGS Workshop

Presented by
Korea Deposit Insurance Corporation (KDIC)

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KDIC Korea Deposit Insurance Corporation

1. Crisis Preparedness and Crisis Management in Korea

- Past Experience in Crisis Management
- Legal and Organisational Framework
- Interagency Cooperation and Coordination
- Supervisory Framework for Problem Insurers
- System-wide Contingency Plans

Past Experience in Crisis Management - 1

❖ Guiding principles for the successful management of the 1997 Asian Financial Crisis

- Bold and decisive measures are required to regain market confidence after the crisis.
- Although Government will take the lead in crisis management initiatives, private capital should be encouraged to fully participate in the process.
- Bank recapitalisation and creation of a bad bank are not mutually exclusive options.
  - The crisis management measures should be politically acceptable and have built-in exit strategies with clear time-frames.
- Moral hazard should be minimised.
- All forms of financial protectionism must be rejected.

Past Experience in Crisis Management - 2

❖ **Policy measures that helped the Korea to wear away the immediate effects of the global financial crisis in 2008**

- Currency swap agreement with the United States (Oct. 2008)
- liquidity injection (by Central Bank) via repos to securities companies and asset management companies (Nov. 2008)
- Establishment of Bond Market Stabilisation Fund (Nov. 2008)
- Expansion of the SME support through policy banking institutions (Korea Development Bank & Industrial Bank of Korea)
- Establishment of Bank Recapitalization Fund in order to enable banks to sufficiently support the real sector and lead the restructuring process (Feb. 2009)
- Establishment of Corporate Restructuring Fund within the Korea Asset Management Corporation (KAMCO) (Mar. 2009)

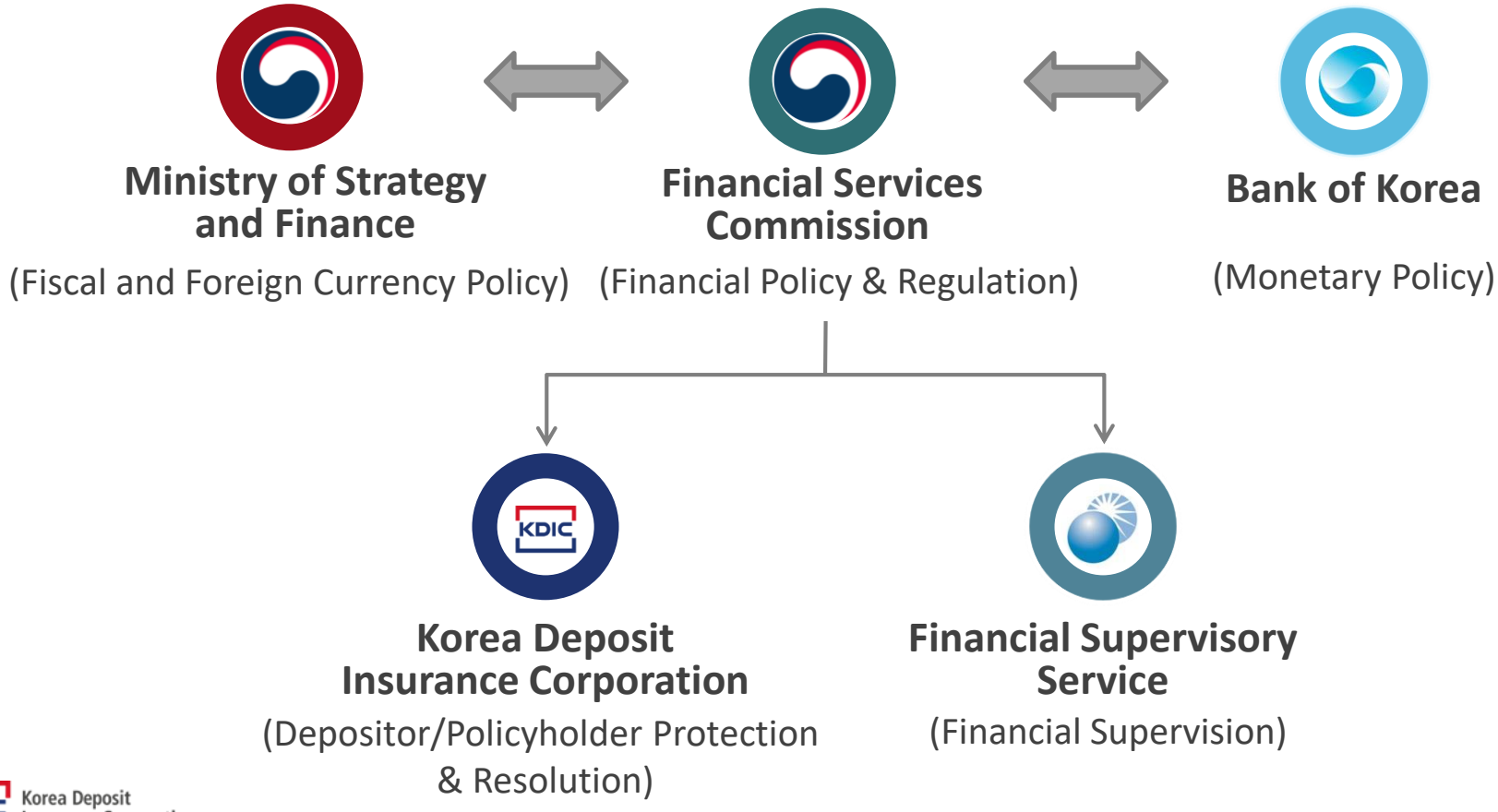
Past Experience in Crisis Management - 3

❖ **Measures for the Savings Bank sector to address sector-wide stress and declining depositor confidence**

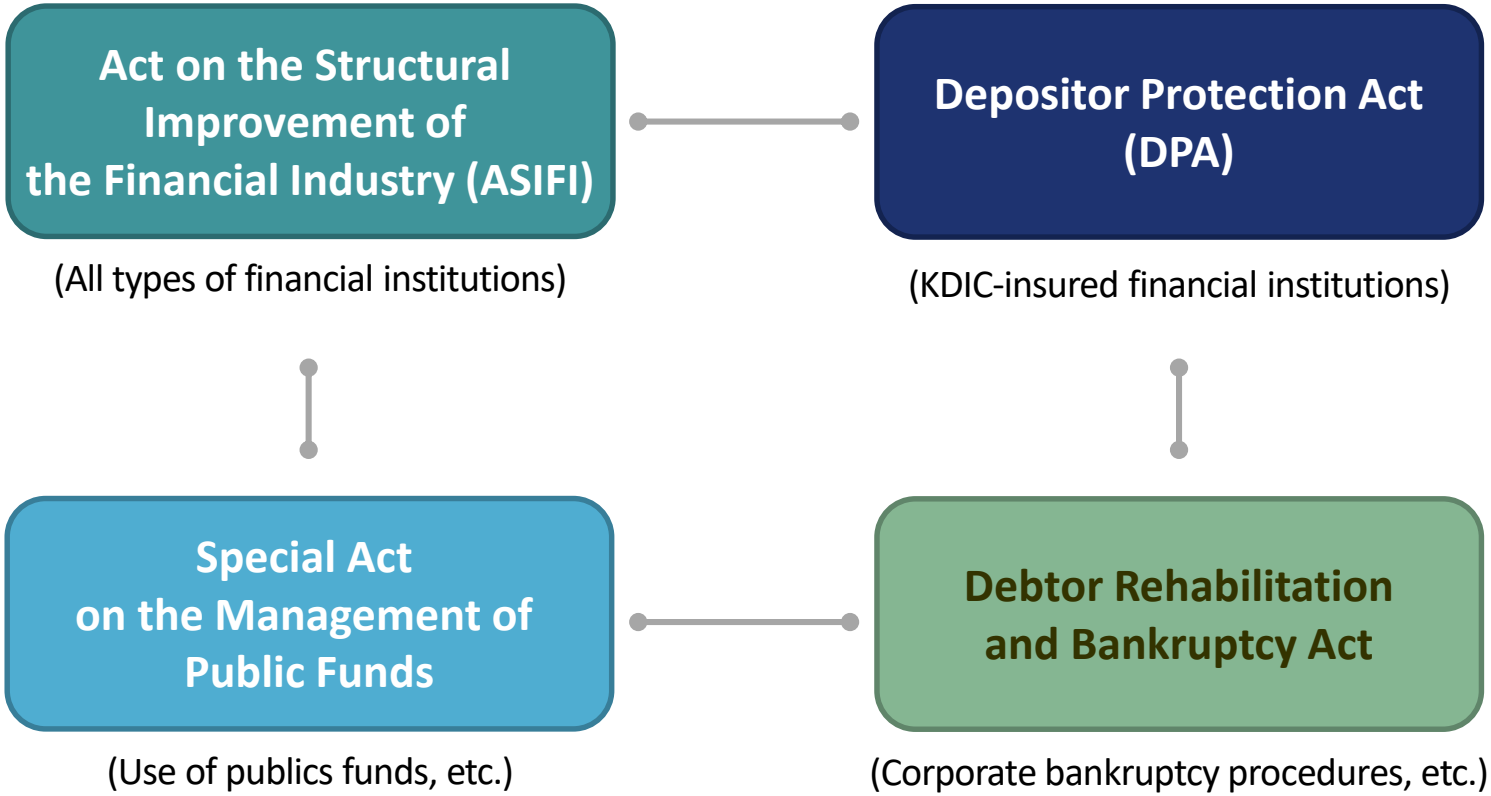
- Joint examinations on a regular basis (by FSS and KDIC)
- Establishment of funding arrangements to provide liquidity and solvency support to Savings Banks
- Establishment of a counselling and support centre to assist the defrauded depositors
- Creation of a special account in addition to the deposit insurance fund within KDIC to support resolution of troubled Savings Banks

Legal and Organisational Framework - 1

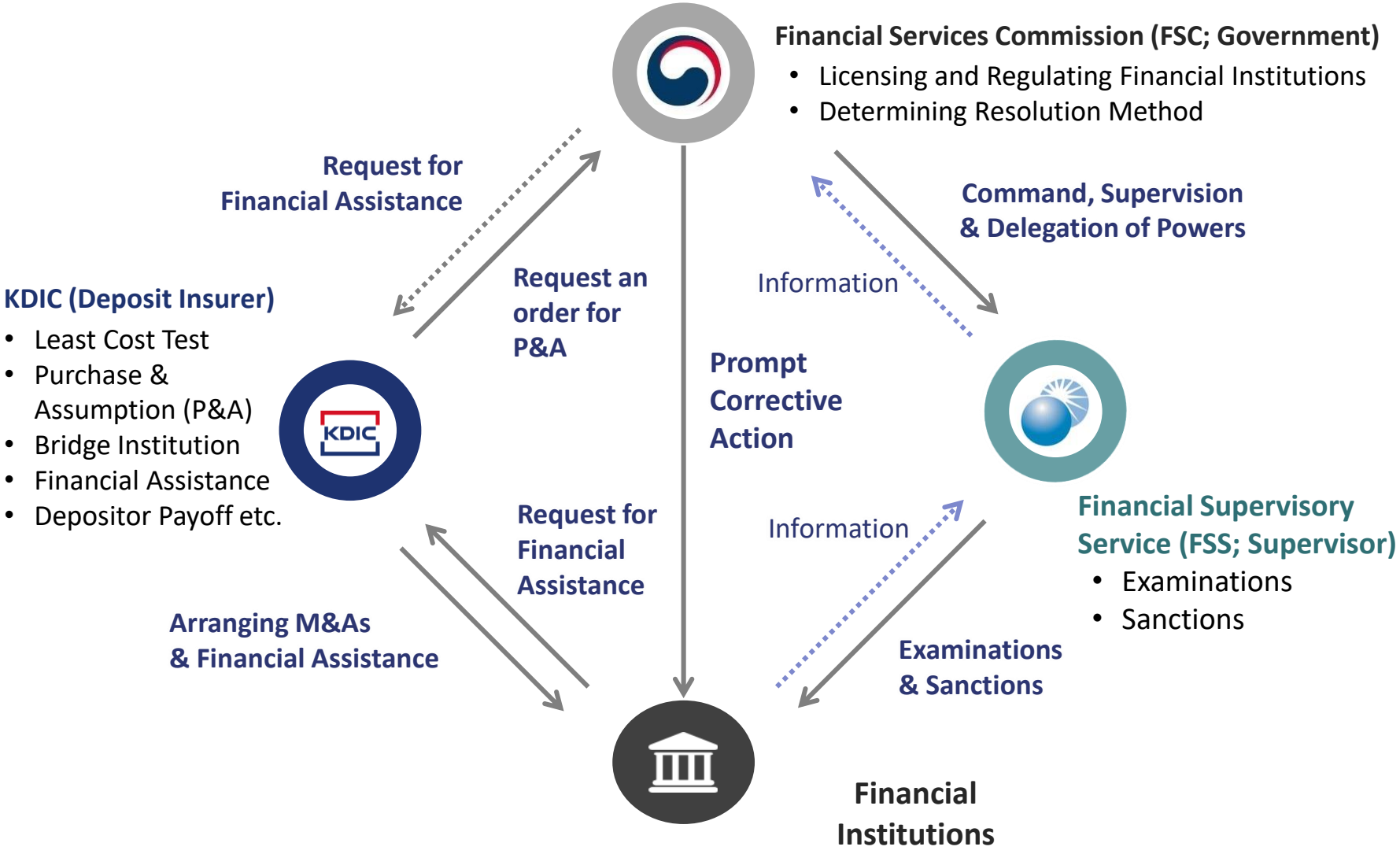
❖ **Clear allocation of the mandates and powers for financial sector oversight amongst financial safety net players**



Legal and Organisational Framework – 2



Legal and Organisational Framework – 3



Interagency Cooperation and Coordination

❖ Interconnectedness of Authorities' Decision-making Bodies

Name	MOSF	BOK	FSC	FSS	FSC-SFC	KDIC	OTHERS
Macroeconomic Financial Meeting	**Chair:** Vice Minister	Senior Deputy Governor	Vice Chair	Senior Deputy Governor	-	Vice President	-
Bank of Korea (Monetary Policy Committee)	Vice Minister (non-voting member)	**Chair:** Governor and Sr. Deputy. Governor	Vice Chair (non-voting member)	-	-	-	Five other members (one member each recommended by BOK, MOSF, FSC, Korea Chamber of Commerce & Industry, and Korea Federation of Banks)
Financial Services Commission	Vice Minister	Senior Deputy Governor	**Chair:** FSC Chairman & FSC Vice Chair	Governor	-	President	Three external members including one recommended by Chamber of Commerce
FSC– SFC	-	-	-	-	**Chair:** FSC Vice Chairman	-	One standing commissioner and three non-standing commissioners
Deposit Insurance Committee	Vice Minister	Senior Deputy Governor	Vice Chair	-	-	**Chair:** President	Three external members
Financial Supervisory Services	-	-	-	**Chair**: Governor, Senior Deputy Governor	-	-	-

Supervisory Framework for Problem Insurers - 1

❖ Corrective Action Framework

– FSC triggers corrective actions when the safety and soundness indicators fall below the threshold levels established in regulations.

Management Improvement Recommendation

- Risk-Based Capital Ratio (RBC) < **100%**
- Rating-as-a-Service (RAAS*) : Class 3 or higher
  * composed of 7 key components (quantitative : qualitative = 60:40)
- Financial irregularity or NPLs of considerable magnitude

Management Improvement Requirement

- Risk-Based Capital Ratio (RBC) < **50%**
- Rating-as-a-Service (RAAS) : Class 4 or lower
- Financial irregularity or NPLs of considerable magnitude
- Failure to implement the improvement plan requested by the FSC's Recommendation

Management Improvement Order

- Risk-Based Capital Ratio (RBC) < **0%**
- Insurers defined as "failing insurers" under ASIFI
- Failure to implement the improvement plan requested by the FSC's Requirement

Supervisory Framework for Problem Insurers - 2

❖ Determining factors that invoke FSC's remedial actions

- Shortage of reserves and assets for future payment to policyholders, default of external debts, and other similar situations due to the rapid deterioration of liquidity
- Cases where it is impossible and difficult to conduct normal businesses due to the unexpected accidents such as shutdown, suspension of business, insurance run, and labour disputes, etc.
- Cases where bankruptcy or insolvency is highly expected

❖ The range of emergency measures

- restriction on taking insurance premiums and granting credits, suspension of payment of all or parts of insurance payouts, prohibition of debt repayment, and disposal of assets

System-wide Contingency Plans

❖ Detailed and Adequate Contingency Plans

- Macroeconomic Financial Meeting (MEFM): To discuss the response measures proposed by each regulator, and to seek an agreement for the package of those measures as appropriate for the level of stress
- Crisis Management Teams (CMTs): To identify key officials tasked with executing crisis preparedness and crisis management related activities
  - Finalising the internal procedures and processes, preparation and maintenance of the documents identified, interacting with the secretariat of the MEFM, and implementation of crisis response measures
- Crisis management handbook or reference materials
  - crisis management protocols/procedures
  - extracts of relevant sections of laws and regulations
  - summaries of key policies
  - templates of key documents that might need to be issued
  - regularly updated lists of relevant stakeholders with contact details
  - communication protocols

2. KDIC's Crisis Management Framework

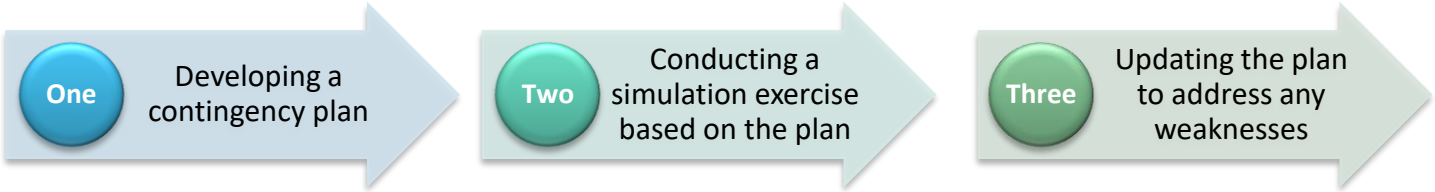
- KDIC's Contingency Planning
- Stages of Financial Crises
- Leading Indicators of Financial Crises
- Crisis Management Team (CMT)
- Standard Operating Procedures (SOPs)

KDIC's Contingency Planning - 1

❖ The scope of the KDIC's contingency planning

– Limited to that which the Depositor Protection Act (DPA) allows for specific situations *(e.g. bank runs, back-up funding, IT emergency etc.)*

❖ Ordinary planning cycle



❖ Key components of the KDIC's CSE Playbook

– **Overview**: definition of a crisis, contingency planning framework, major actions at each level of crisis, potential channels of contagion, and KDIC's roles

– **Standard Operating Procedures** (SOPs): in each crisis phase and situation, what should do and what should refer to *(relevant laws and regulations, manuals and handbooks, reference cases, etc.)*

– **Scenario-by-scenario action plans**: assuming several crisis scenarios that are most likely to occur

KDIC's Contingency Planning - 2

❖ Designing a scenario

- Military provocation by North Korea
- Recession of the global and/or regional economy
- Breakout of a global financial crisis

❖ Testing and updating the CSE Playbook

- KDIC keeps updating its CSE Playbook by incorporating material changes in laws, regulations and policies
- Also reflects recent developments regarding inter-agency cooperation and coordination
  - e.g. the findings from the joint exercise amongst financial safety net agencies of Korea during the previous year's CSE

Stages of Financial Crises

Level 0: Attention

- Temporary financial instability
- Radical changes in the market indicators (stock prices, foreign exchanges, interest rates)

Level 1: Alert

- Continuation of the financial instability
- Possible insolvency of the KDIC-insured financial institutions

Determined by market / leading indicators

Level 2: Escalation

- Business suspension of several financial institutions (non-bank sectors)
- A large demand for the KDIC's funds due to bank runs and insurance runs

Level 3: Full-blown Crisis

- Business suspension of a number of financial institutions including major commercial banks
- Massive disruption to the nation's financial system

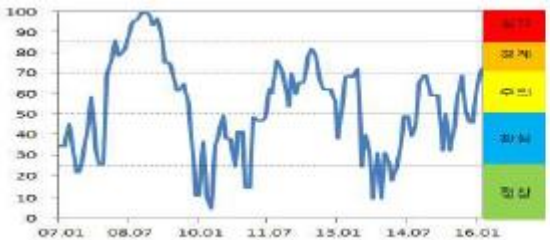
Determined by the occurrence level of the KDIC's insurance events

Leading Indicators of Financial Crises - 1

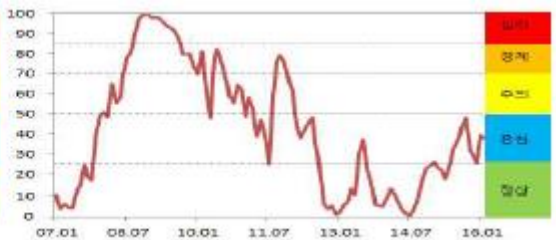
❖ Early Warning System (EWS)

- Operated by the Financial Services Commission (FSC)
- Composed of 3 indicators; based on qualitative analyses by the seven experts from market and relevant authorities (inc. KDIC)

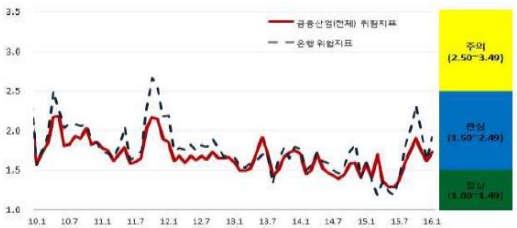
① Financial Markets Indicator



② Financial Stress Indicator

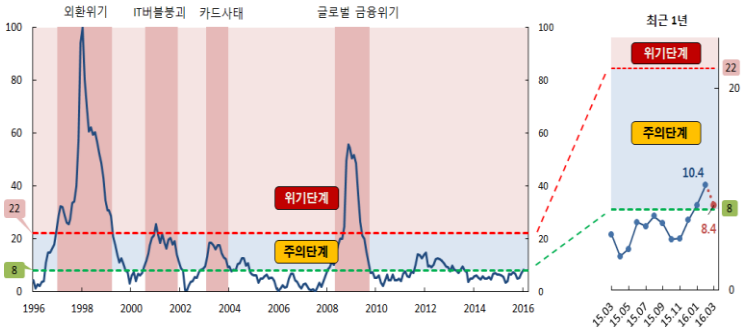


③ Financial Industries Indicator



❖ Financial Stability Index (FSI)

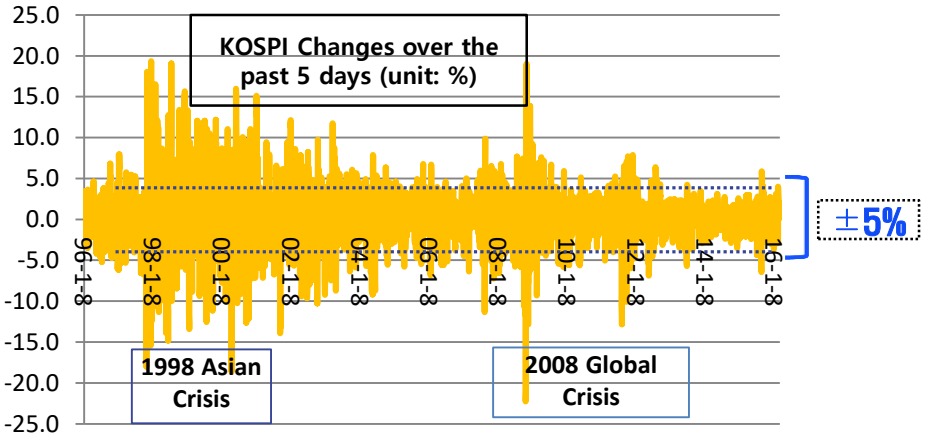
- Operated by the Bank of Korea (BOK)



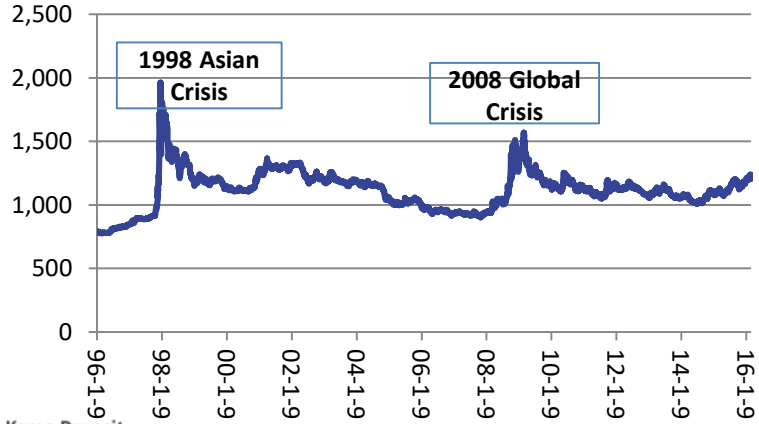
Leading Indicators of Financial Crises - 2

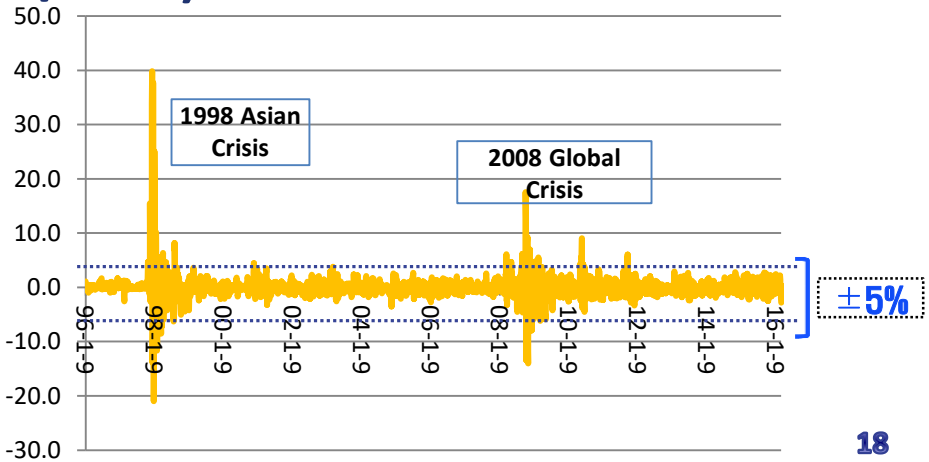
❖ Korea Composite Stock Price Index (KOSPI)

– The representative stock market index operated by the Korea Exchange



❖ Foreign Exchange Rate (USD/KOR)





Crisis Management Team (CMT)

❖ **CMTs are tasked with executing crisis management activities.**

- Finalising the internal procedures and processes
- preparing and maintaining the documents identified
- interacting with the secretariat of the MEFM
- implementing of crisis response measures according to the SOPs

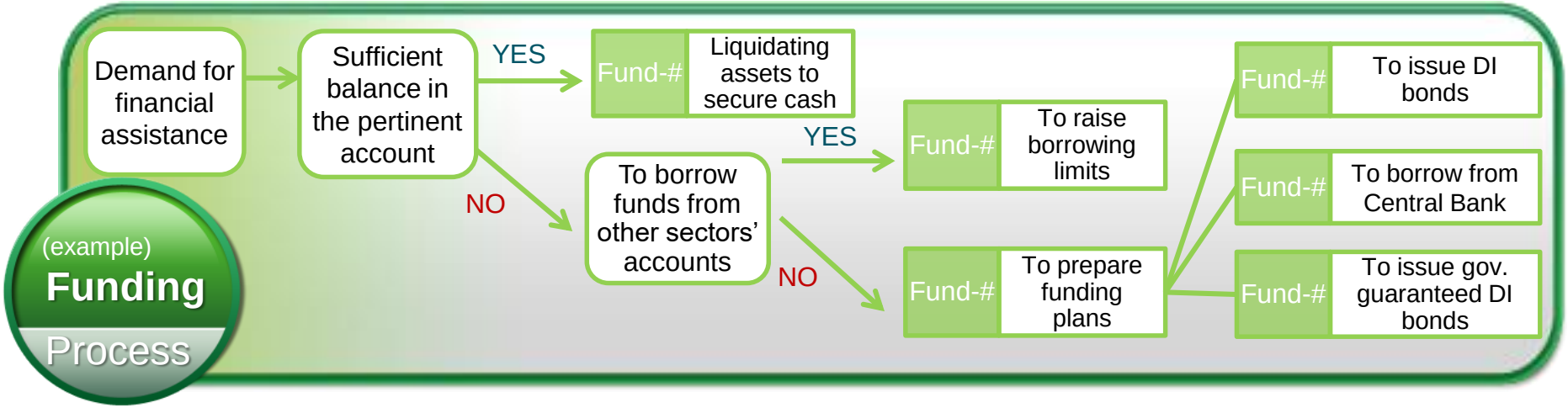
Level 0: Attention	Level 1: Alert	Level 2: Escalation	Level 3: Full-blown Crisis
• The meetings are organised by the Risk Monitoring Department. • Analysing the financial information from the market and KDIC-insured institutions	• The meetings are organised by the Risk Monitoring Department. • Monitoring the possible risk of a financial crisis • Discussing the preventive measures to address a crisis	• The meetings are organised by the Resolution Planning Department. • Reviewing recovery and resolution plans • Determining resolution methods	• The meetings are organised by the Resolution Planning Department. • Reviewing restructuring plans for financial industries • Preparing funding plans (inc. public funds option)

Standard Operating Procedures (SOPs)

❖ Modularised work process for each crisis situation

– Real-life situation modules, which cover the following areas:

- Crisis Communication, Inter-agency Coordination, Public Relations, Responding to Depositors, Policyholders and Other Stakeholders, Risk Monitoring, Market Stabilisation, Resolution Process, Resolution Methods, Funding Process, Back Funding Sources, Asset Recovery, Accountability Investigation and IT Functions etc.



3. KDIC's Crisis Simulation Exercise (CSE) in 2023

- Overview of the Exercise
- Details of the Scenario
- Joint Exercise with KSFC
- Key Takeaways

Overview of the Exercise

- **When?**
  - 21 - 23 August 2023 *(3 days)*
- **Who participated in?**
  - All the executives and staff members of the KDIC
- **What was the scenario?**
  - Simultaneous failures of a number of KDIC-insured financial institutions, which include Savings banks and Digital-only banks as well as Securities firms (Investment traders & Brokers) and Insurance firms
- **How did they conduct the Table-top exercise?**
  - Online: Right after disseminating news and notices, the taskforce in charge quickly respond to them with relevant action plans
  - Offline: Emergency meetings are held to steer the exercise, and discuss the counter-measures and action plans

Details of the Scenario

❖ Contagion effect - Chain reaction from Saving banks with high-risk exposure to other financial sectors

Credit crunch in the real estates related investments due to the sharp decrease in the demand for housing

→

Increase of overdue loans and depreciation of the collateral values
→ liquidity outflows from KDIC-insured FIs

Risk Monitoring

- Daily liquidity monitoring
- Joint examination w/ Supervisor
- Stress testing

Resolution of Problem Banks & Insurers

- Resolution planning
- Prep for bidding process
- Depositor reimbursement
- Insurance policy Transfer

Accountability Investigation

- Planning for Investigation
- Filing a damage claims against insolvency-implicated Persons

Asset Recovery

- Appointment of a Trustee for bankruptcy estates
- Liquidating estates by selling remaining assets
- Dividend payments to creditors

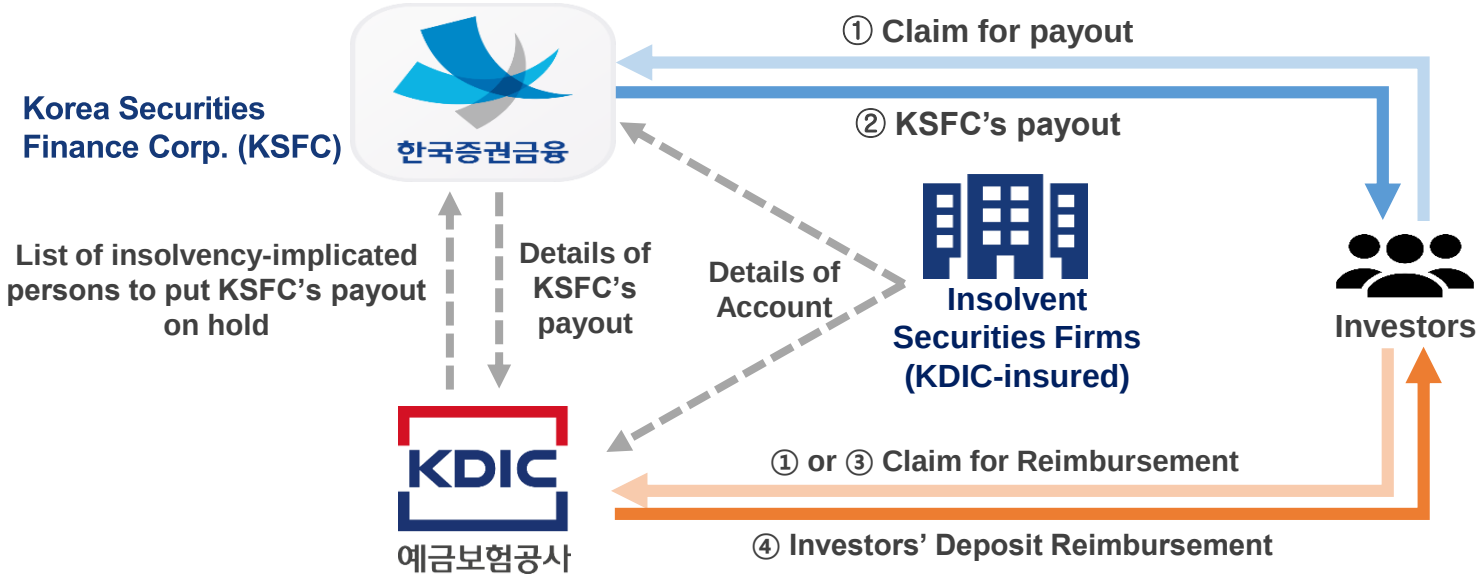
Joint Exercise with KSFC

❖ To reflect recent changes in the priority of investors' deposit reimbursement

Amendment to the Financial Investment Services and Capital Markets Act

KSFC pays out to investors with its custody fund.
→ KDIC reimburse the shortfalls of the investors' deposits up to the KDIC's coverage limit.

Workflow of Investors' Deposit Reimbursement



Key Takeaways

❖ Organization-wide capacity building

- Realistically assessed the KDIC's capacity from the early stage to the full-scale sector contagion
- Focused on practical action plans to effectively deal with a stressed financial institutions in various situtations

❖ Collaboration with KSFC

- Prepared Interagency cooperation and coordination simulating a financial crisis in the capital market