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Financial Supervisory Service
Mr. Kim, Won-Ho
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Email : fxco@fss.or.kr

Re: Risk Management Guidelines for FX Derivatives Transactions

Dear Mr. Kim,

On behalf of the International Swaps and Derivatives Association, Inc. (“ISDA”), we are writing to you with regard to the proposed Risk Management Guidelines for FX Derivatives Transactions under the Banking Regulations (“Draft Guidelines”) released for comments from the industry by Financial Supervisory Services (FSS) on November 26, 2009. As you may be aware, ISDA is the leading global trade association in the privately negotiated or over-the-counter derivatives industry with over 840 members from more than 58 countries worldwide, including many Korean members. ISDA’s membership also includes many of the international banks who introduce the majority of new OTC derivative products into the Korean market. ISDA’s primary purpose is to encourage and assist in the establishment of sound financial risk management systems and to ensure the prudent and efficient development of derivative markets.

ISDA applauds the effort of the FSS to strengthen risk management in the financial services industry and in particular to encourage corporations to adopt appropriate FX hedging strategies. Our concern is mainly with the mechanics of implementing the prescribed solution as we believe that it places too much of the burden on the hedge providing banks and would not be effective without changes to Korean banking privacy laws. Our reasoning is set out below.

- 1) Before entering into an FX hedging trade with a counterparty, the hedge providing bank would have the obligation to verify the hedging need through examination of evidence of an underlying transaction need and to make sure that the hedge ratio does not exceed 125% of exposure for a corporate investor falling under the scope of “professional investor” under the Financial Investment Services and Capital Market Act (“FSCMA”) or 100% for a general investor.
- 2) The Draft Guidelines impose additional obligations on the banks that are not required under FSCMA. The proposed obligations to verify the hedging needs by the banks even when trading with professional corporate investors seem to be much higher than the obligations to verify hedging need when trading with general investors under FSCMA. Under FSCMA, the banks are not subject to strict obligations to verify hedging needs if the counterparty corporate is a professional investor. The new set up guidelines would

apply to banks, but not securities companies. Therefore, the market will operate under two sets of different regulations. This will cause confusion in the market and put the banks at a competitive disadvantage. Furthermore, it seems to directly contravene the regulatory policy framework that the Korean government brought into being earlier this year through FSCMA.

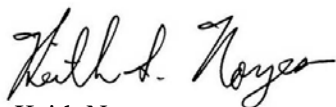
- 3) It is not clear whether evidence of an underlying transaction is meant to refer to individual underlying transactions, aggregate transactions over a one year time period (rolling or fixed year end?) or a longer time frame.
- 4) Furthermore, is it based upon gross exposure (such as export receipts) or net exposure (for example, the counterparty needs to import raw materials before manufacturing the finished product for export)? In any case, the burden on banks to verify the hedging need exposes them to a heavy burden and tremendous potential liability. It would be much fairer for the hedging counterparty to provide certification in writing from its board what its total hedging needs are at the time of the trade, though this still raises the question of what happens if certain export contracts are subsequently cancelled and this causes the hedge ratio to exceed the cap.
- 5) Currently the Draft Guidelines provide that the bank check the hedge ratio of the counterparty on a daily basis and if such limit is exceeded, the bank should suspend new trading, collect collateral or enter into offsetting trade(s). This is a very unrealistic requirement given that the hedge ratio itself seems to be an arbitrary standard, and complying with this guideline will make doing business in Korea very expensive. Ultimately, these costs will have to be passed on to the end users looking to hedge their business risks.
- 6) Draft Guidelines also provide that banks should notify the reasons for rejecting a trade. This raises concerns since banks don't usually disclose the credit limit to the counterparties.
- 7) After the validity of the hedging need has been determined, the bank would then need to confirm that the counterparty would not exceed its hedge ratio by entering into the hedging transaction. This requires the bank to consult a trade data base maintained by the Korean Federation of Banks (KFB) that in theory would contain all FX hedging trades entered into by the counterparty. ISDA understands that many of the largest FX hedge providers in the market do not currently partake in the KFB data base and that without specific consents from clients to supply this data that banks would not be able to do so under existing privacy laws. Therefore, a change in laws to make this information sharing mandatory would be required before the data could be considered reliable for compliance with the hedge verification requirement.
- 8) We note that under the Draft Guidelines, if the bank wishes to enter into a trade that would exceed the hedge ratio for professional corporate investors, then it is required to get the approval of its own risk management department. This would seem to give banks carte blanche to allow corporate to exceed the hedge ratio anytime they wish to do so and wonder what this carve out is intended to accomplish.
- 9) If a Korean corporate were to trade with an offshore bank on a reverse inquiry basis, the offshore bank would not have any obligation to report the trade to the data base. This could result in onshore banks having incomplete information at the time they verify whether or not their trade would exceed the corporation's hedge ratio.

- 10) A related concern is that banks would not want to reveal their derivative positions to competitors. It is one thing for end users to have their aggregate positions recorded in the data base, but for banks there is considerable downside risk. This is because as soon as the bank enters into a hedging transaction with a counterparty, it will immediately try to lay the position off in the market. If competing banks are able to discover from the data base that a bank has built up a large exposure while facilitating the end users' hedging trade, then those competing banks could move the market to the disadvantage of the hedge providing bank. For example, the hedging bank sells Korean Won calls at a particular volatility to the end user. The bank must then purchase volatility in the interbank market. If other banks know that a particular bank is very short volatility then their offer price for that volatility will increase. This will result in an increase in the cost of providing the hedge with negative cost repercussions that will ultimately be passed on to the end user.
- 11) A related technical issue is the form in which banks provide data to KFB and whether that would lead to misleading information about hedge exposures. The format for all data reporting must be agreed upon and standardized before banks could comfortably rely on the numbers in the data base for verifying the hedge ratio.
- 12) Also unclear is whether the guidelines are meant to apply to Korean Won/foreign currency transactions only or if they would also apply to foreign currency/foreign currency transactions. In the global economy, there could be scenarios under which a Korean corporation might need to hedge dollar/yen or Australian dollar/Euro exposure for example. The Draft Guidelines require banks to set up risk management procedures for spot transactions as well, but it is not clear what procedures should be followed in this regard. The Guidelines also impose trading limits for banks with non-resident entities. This will only restrict the ability of banks to hedge their own positions with offshore entities and make them less able to meet the hedging needs of Korean corporations.

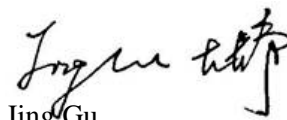
ISDA thanks you in advance for your attention to this matter. Should you or your colleagues have any questions regarding international practices or would like an elaboration on the issues raised in this letter, please do not hesitate to contact Mr. Keith Noyes (knoyes@isda.org) in Hong Kong at telephone number +852 2200 5909 or Ms. Jing Gu (jgu@isda.org) at +852 2200 5908.

Yours sincerely,

For The International Swaps and Derivatives Association, Inc.



Keith Noyes
Asia Pacific Regional Director



Jing Gu
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