

### **3.33 SOUTH KOREA**

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#### **I. FRAMEWORK**

##### **Efforts to create a covered bond market in Korea**

The Covered Bond Act of Korea (the "Covered Bond Act") was passed by the National Assembly on 19 December 2013 and came into effect on 15 April 2014. Prior to the enactment of the Covered Bond Act, domestic banks in Korea had been looking at covered bonds as a potential alternative source of funding and the Korea Federation of Banks, a major association of banks in Korea, set up a task force team in 2008 to pursue the introduction of covered bonds in Korea, including by way of a dedicated covered bond statute. Even prior to the Korea Federation of Banks task force team, market participants were looking into alternative structured covered bond structures utilising Korea's Act on Asset-Backed Securitisation (the "ABS Act").

Such efforts eventually led to Kookmin Bank's offshore covered bond issuance in May 2009 (the "KB Structured Covered Bonds"). Kookmin Bank developed a structure on the basis of the securitisation techniques under the ABS Act and the Trust Act that enabled the relevant asset pool to be "ring fenced" and effectively granted dual-recourse to its investors through contractual arrangements. The KB Structured Covered Bonds were the first covered bonds issued out of Korea and the Asia-Pacific region.

Many Korean banks looked into possible issuance of similar structured covered bonds after Kookmin Bank's inaugural transaction. Due to the complex structure and favorable market conditions allowing banks to procure funding at acceptable rates, Korean banks did not follow through with covered bond issuance under the Kookmin Bank structured covered bond model.

Separately, in July 2010, the Korea Housing Finance Corporation ("KHFC") issued the second covered bond out of Korea and the first statutory covered bond transaction out of Asia. KHFC utilised the "mortgaged-backed bonds" (the "KHFC Covered Bonds") under the Korea Housing Corporation Act (the "KHFC Act") in issuing the covered bonds. The KHFC Act contemplates various financing options for KHFC and to issue mortgage-backed bonds is one of these options. Mortgaged-backed bonds are economically similar to covered bonds because the bond holders have a statutory priority right over a pool of assets segregated from the other assets of KHFC.

The successful issuance of the KHFC Covered Bonds in 2010 stimulated new interest for covered bonds in Korea, with KHFC Covered Bonds being considered as a potential alternative to traditional residential mortgage backed securities (RMBS) transactions as a funding source for Korean mortgage lenders. Several follow-on transactions have been completed that utilise KHFC as the issuer and the dual recourse feature of mortgage-backed bonds under the KHFC Act.

Following the enactment of the Covered Bond Act, on 12 June 2015, Kookmin Bank became the first bank in Korea to set up a global covered bond programme pursuant to the Covered Bond Act and list it on the Luxembourg Stock Exchange. KB Covered Bond Programme was the first covered bond programme by an Asian financial institution that was listed and obtained ratings of AAA and Aaa from Fitch and Moody's, respectively. These ratings were higher than Kookmin Bank's ratings (AA1) and even Korea's sovereign ratings (AA, Aa2) and this enabled Kookmin Bank to procure funds from the offshore market at reduced cost in subsequent issuances. On 21 October 2015, Kookmin Bank issued the first covered bonds under the KB Covered Bond Programme in the amount of \$500 million with five-year maturity and this led to the second issuance on 3 February 2016, also in the amount of \$500 million with five-year maturity. Following these successful issuances by Kookmin Bank, other commercial banks are showing increased interest in covered bonds as an alternative, long-term funding source.

In a household debt management meeting held on 16 April 2018, the Financial Services Commission (the "FSC"), which is the main financial regulator in Korea, announced measures to utilise covered bonds as a

means to procure funding for long-term, fixed-rate household loans. The plan is to link the allocation of eligible loans acquired by KHFC to the covered bond issuance of each bank so that KHFC acquisition of eligible loans is allocated more to banks with robust covered bond issuances. In addition, the plan is to allow banks and insurance companies to apply relaxed weighted risk standards on covered bonds starting in 2022 and 2021, respectively. Domestic issuances of covered bonds will be able to benefit from lower commission rate paid to the Financial Supervisory Service (the "FSS").

## **II. STRUCTURE OF THE ISSUER**

### **1. KHFC Act**

#### **Eligible issuer**

KHFC, which is wholly owned by the Korean government and the Bank of Korea, is the only eligible issuer of KHFC Covered Bonds. Pursuant to Article 31 of the KHFC Act, the holders of KHFC Covered Bonds have a statutory priority right of payment from a separately managed pool of mortgage loans designated as the underlying collateral for KHFC Covered Bonds (the "KHFC Cover Pool"). In addition, if principal and interest on a KHFC Covered Bond are not fully paid out of the KHFC Cover Pool, it can be paid from the general assets of KHFC. KHFC issues these bonds without transferring the cover assets to a separate legal entity and the bankruptcy remote cover assets are left on KHFC's balance sheet.

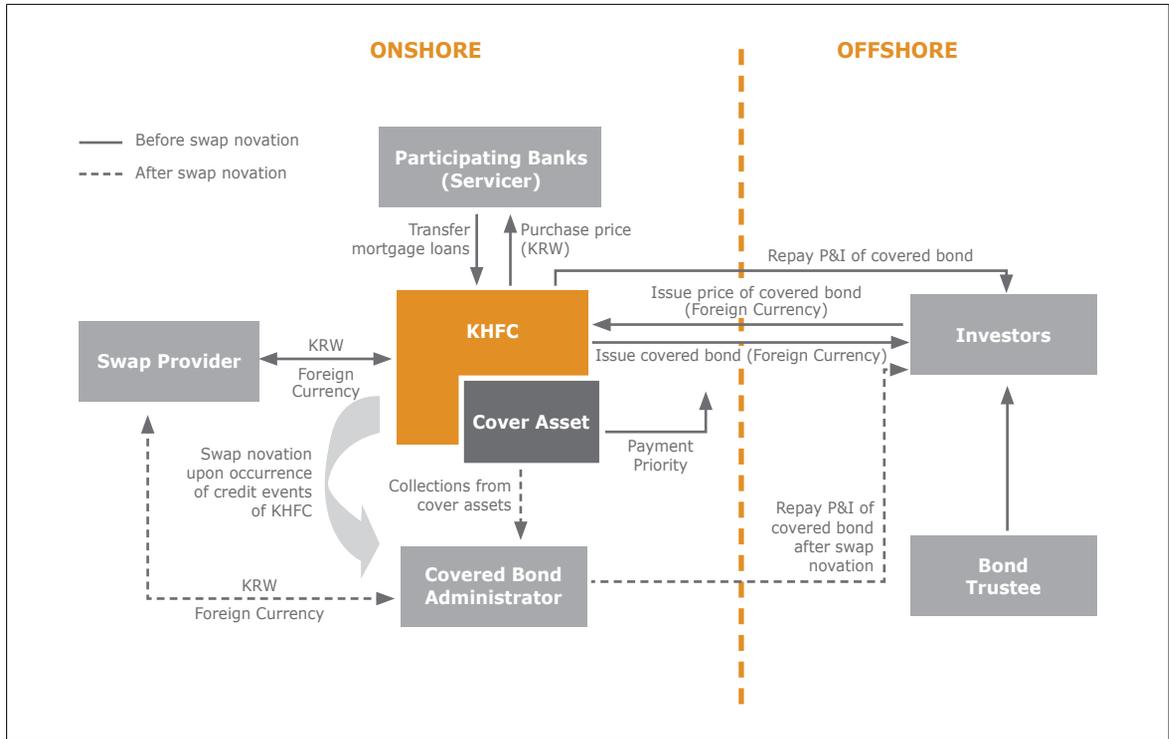
A bond trustee is typically appointed to act on behalf of the investors and an onshore covered bond administrator is appointed for the purpose of the automatic swap novation described below. The investors have dual recourse in respect of the KHFC Covered Bonds: (a) a senior unsecured claim to KHFC prior to the occurrence of an issuer event of default or at maturity; and (b) a statutory priority right of payment over the KHFC Cover Pool upon the occurrence of an issuer event of default.

In the case of KHFC Covered Bonds issued offshore, KHFC enters into a cross currency swap agreement and an interest rate swap agreement with the swap providers, pursuant to which KHFC will deliver KRW interest periodically and principal at maturity to the swap providers in exchange for foreign currency payments. The swap providers pay foreign currency denominated interest periodically and principal at maturity. The swap agreement is subject to an automatic swap novation mechanism (the "Swap Novation") in which the swap providers, KHFC, and the covered bond administrator entered into a tripartite automatic novation agreement at the closing date, which states that the swap agreement will be automatically terminated with KHFC and novated to the covered bond administrator upon the occurrence of certain events of default regarding KHFC, and that the mark-to-market valuation of the swap agreement as of the novation date will not be exchanged between KHFC and the swap providers or between KHFC and the covered bond administrator.

Subsequent to such events of default, the covered bond administrator will pay KRW generated from the KHFC Cover Pool to the swap providers in exchange for the foreign currency denominated payments, and the swap providers will pay the foreign currency denominated interest periodically and principal at maturity.

The following diagram illustrates the structure of the KHFC Covered Bonds transaction.

FIGURE 1: KHFC COVERED BONDS TRANSACTION STRUCTURE



Source: Kim & Chang

### Issuance limit

KHFC may issue KHFC Covered Bonds up to 50 times of its paid-in equity capital.

## 2. Covered Bond Act

### Eligible issuer

Eligible issuers of covered bonds under the Covered Bond Act (the "Covered Bonds") include (i) banks licensed and established under the Bank Act of Korea, (ii) the Korea Development Bank under the Korea Development Bank Act, (iii) the Export-Import Bank of Korea under the Export-Import Bank of Korea Act, (iv) the Industrial Bank of Korea under the Industrial Bank of Korea Act, (v) NH Bank under the Agricultural Cooperatives Act, (vi) the credit business division of National Federation of Fisheries Cooperatives under the Fisheries Cooperatives Act, (vii) KHFC under the KHFC Act, or (viii) any other company engaging in finance business pursuant to other laws as prescribed by the Presidential Decree of the Covered Bond Act (the "Presidential Decree"). The Presidential Decree came into effect on 15 April 2014 and does not stipulate any additional eligible issuers other than those already set out in the Covered Bond Act. Eligible issuers of Covered Bonds, however, must have equity capital of not less than KRW 100 billion, Bank for International Settlements (BIS) ratio of not less than 10%, and appropriate funding and operation structures and risk management procedures, etc.

### Issuance limit

The Covered Bond Act prescribes that eligible issuers may issue Covered Bonds up to the ceiling set by the Presidential Decree which shall not exceed 8% of its total assets as of the end of the fiscal year immediately preceding the scheduled date of issuance and the Presidential Decree limits this to 4% of its total assets as

of the end of the fiscal year immediately preceding the scheduled date of issuance. The FSC, as the Korean financial regulator, reserves the right to restrict this further to 2% of its total assets taking into consideration various factors, such as collateralisation ratio and financial condition including liquidity position.

### **III. COVER ASSETS**

#### **1. KHFC Act**

The mortgage loans in the KHFC Cover Pool are acquired from certain Korean financial institutions that function as the originating banks. The individual mortgage loans included in the KHFC Cover Pool may change from time to time as a result of substitutions by KHFC, and KHFC is responsible for ensuring that the mortgage loans are properly serviced and will delegate its servicing responsibility to the originating banks, with each originating bank servicing those mortgage loans originated and sold by it to KHFC.

#### **2. Covered Bond Act**

The cover pool (the "Cover Pool") shall comprise of (1) the Underlying Assets, (2) the Liquid Assets and (3) Other Assets. The "Underlying Assets" shall include (i) residential mortgage loans with 70% or lower loan-to-value (LTV) ratio and first priority mortgage, obligors of which are not subject to insolvency proceedings, (ii) loan receivables against the government, a local government or a corporation incorporated under the special laws, (iii) Korean Treasury bonds, municipal bonds or bonds issued by a corporation incorporated under the special laws, (iv) mortgage loans secured by ships or aircraft with 70% or lower LTV ratio and is insured for an amount in excess of a prescribed minimum level (which is currently 110% of the sum of (a) the aggregate outstanding balance of the relevant loan and (b) any other outstanding debt of the issuer that are at least *pari passu* with such loan) and (v) asset backed securities issued under the ABS Act and KHFC Covered Bonds and residential mortgage backed securities issued pursuant to the KHFC Act. The following limitations are applicable to the residential mortgage loans comprising the Underlying Assets: (x) at least 20% must have a debt-to-income (DTI) ratio of 70% or less, (y) at least 30% must be fixed rate loans, and (z) if there are residential mortgage loans of which 50% or more of their outstanding principal balance may be set off against the relevant issuer, such residential mortgage loans should comprise 10% or less of all residential mortgage loans. The "Liquid Assets" shall comprise of cash, certificates of deposit with a maturity of no more than 100 days issued by financial companies other than the issuer of the Covered Bonds, bonds issued by any government as prescribed by the FSC, financial instruments issued by foreign financial companies as prescribed by the FSC similar to the certificates of deposit referred to above and deposits and term deposits at either domestic or foreign financial companies with maturity of 3 months or less. Finally, "Other Assets" shall comprise of collections and other property rights acquired from the Underlying Assets and the Liquid Assets and the claims acquired from derivatives transactions executed in order to hedge foreign exchange rate or interest rate risks and other risks associated with the cover pool pursuant to the Covered Bond issuance plan.

### **IV. VALUATION AND LTV CRITERIA**

#### **1. KHFC Act**

KHFC's detailed rules for the purchase of residential mortgage loans stipulates the requirements of such loans that it can acquire from financial institutions, prescribing that if the DTI ratio is in excess of 60% but no higher than (a) 100% in the case of residential mortgage loans that were transformed from a bullet payment structure to 10+ years instalment payments for repayment and (b) 80% in the case of residential mortgage loans for newly built residences (this exception will be available until the end of 2018), LTV shall not exceed 70% (or 85% in case payment is guaranteed by a credit guarantee fund or insurance company), while LTV can still be recognised up to 100% as collateral on existing loans in the case of residential mortgage loans that were transformed from a bullet payment structure to 10+ years instalment payments for repayment. The value of

the mortgage housing should not exceed KRW 900 million, the loan limit should be less than KRW 500 million won, and the repayment period should be at least 10 years or longer.

There is no statutory standard for valuation of residential mortgage loans that are included in KHFC Cover Pool. Instead, the valuation methods are set forth in individual transaction documents for the KHFC Covered Bonds which value residential mortgage loans between 100% and 0%, depending on the length of delinquency.

## **2. Covered Bond Act**

LTVs for residential mortgage loans as well as loans secured by ships or aircrafts in the Cover Pool shall be 70% or lower. Valuation shall be carried out by reference to the closing market price of the relevant day on the securities exchange. In cases where no reliable market prices are available on the relevant day, book value, par value, purchase price, transaction price and price provided by an entity which satisfies statutory requirements shall be taken into account, alongside the prevailing exchange rate at the time of valuation. Where derivative transactions have been entered into for the purpose of hedging exposure to movements in foreign currency exchange rates, the exchange rates as specified in such derivative transactions themselves shall be used, and non-eligible assets and derivative transactions shall be valued at "0".

## **V. HEDGING AND ASSET – LIABILITY MANAGEMENT**

### **1. KHFC Act**

In the case of KHFC Covered Bonds issued offshore, the underlying residential mortgage loans are denominated in KRW but the KHFC Covered Bonds are issued in foreign currency and KHFC entered into swap agreements to hedge the resulting currency risk. This swap agreement is subject to the Swap Novation described above.

There are no statutory regulations on overcollateralisation or excess yield of collateralised assets. However, the transaction documents in previous KHFC Covered Bonds have required the KHFC Cover Pool to satisfy an asset coverage test and portfolio yield test and the failure for the KHFC Cover Pool to satisfy the foregoing tests for a certain period of time becomes an issuer event of default which in turn triggers the management of the KHFC Cover Pool to be transferred to a separately appointed covered bond administrator, in addition to the above-mentioned Swap Novation.

### **2. Covered Bond Act**

The total value of the Cover Pool shall be equal to or more than 105% (the "Required Overcollateralisation Ratio") of the total value of the covered bonds and the liquid assets shall not exceed 10% of the total outstanding amount of the Cover Pool. The details of the valuation standard and method, etc. for each type of assets comprising the cover pool are prescribed by the Presidential Decree. The issuer shall prepare and maintain separate books for the management of the Cover Pool. If the total value of the Cover Pool is likely to fall below the Required Overcollateralisation Ratio or cover assets fail to satisfy the Cover Pool eligibility criteria set forth in the Covered Bond Act (the "Cover Asset Eligibility"), the issuer shall add or substitute the Underlying Assets and Liquid Assets without delay in order to comply with the Required Overcollateralisation Ratio and the Cover Asset Eligibility. In this case, the relevant assets shall be deemed to form part of the Cover Pool until the relevant assets are substituted.

Unlike the KHFC Act, the claims acquired from derivatives transactions executed in order to hedge foreign exchange rate or interest rate risks and other risks associated with the Cover Pool pursuant to the Covered Bond issuance plan are included in the Cover Pool as described above and the swap provider also has a priority right of payment from the Cover Pool under the Covered Bond Act. As such, we do not expect there to be a particular need to novate the relevant swap agreement to a third party.

## **VI. TRANSPARENCY**

### **1. KHFC**

To issue KHFC Covered Bonds, KHFC must register a securitisation plan with the FSC and this securitisation plan is available to the public on the FSS website. Amendments to the securitisation plan after the terms and conditions of the KHFC Covered Bonds are confirmed must also be registered with the FSC.

The securitisation plan should include (i) name of KHFC and location of its office, (ii) term of the securitisation plan, (iii) the details, total sum and appraisal value of the residential mortgage loans as cover assets, (iv) types, total sum and issuance conditions of the KHFC Covered Bonds to be issued, (v) matters concerning management, operation and disposition of the residential mortgage loans as cover assets, and (vi) matters concerning the covered bond administrator.

### **2. Covered Bond Act**

Any eligible issuer that intends to issue Covered Bonds must register the Covered Bond issuance plan and details of the Cover Pool with the FSC. The issuer must also register amendments to the issuance plan or the matters concerning the Cover Pool, while minor changes shall be reported to the FSC within seven days from the date of such change. The issuance plan should include (i) the terms and conditions of the Covered Bonds, (ii) qualification requirements of the issuer pursuant to the Covered Bond Act such as equity capital, balance sheet, etc., (iii) the details of the Cover Pool, (iv) total valuation amount and details of such valuation of the Cover Pool, (v) the Required Overcollateralisation Ratio, (vi) details of the Cover Pool monitor and (vii) information relating to protection of debtors, details of further issuance of Covered Bonds if relevant, funding plans for redemption of Covered Bonds and other matters relating to issuance, distribution and redemption of Covered Bonds as prescribed by the FSC.

The issuer is required to establish and monitor at least on a quarterly basis separate risk management standards and procedures relating to the issuance and redemption of the Covered Bonds. The issuer is also obligated to disclose on its website on a quarterly basis the result of risk management monitoring, the report prepared by the Cover Pool monitor and other information necessary. The FSC may request data concerning business or properties of the issuer and its administrator and the Cover Pool monitor, or investigate such business and properties if necessary for protecting the Covered Bond investors.

## **VII. COVER POOL MONITOR AND BANKING SUPERVISION**

### **1. KHFC Act**

There are no explicit provisions in the KHFC Act on the KHFC Cover Pool monitor but independent third parties are appointed to supervise and monitor KHFC's management of the KHFC Cover Pool. For example, an accounting firm has been appointed as the cover pool monitor in previous KHFC Covered Bond issuances to be responsible for confirming whether the KHFC Cover Pool minimum maintenance requirements have been satisfied. In addition, the KHFC Covered Bond administrator is appointed in advance for the management of the Cover Pool in order to protect the KHFC Covered Bond holders upon occurrence of any issuer event of default including a bankruptcy event of KHFC.

### **2. Covered Bond Act**

The issuer shall appoint with the approval from the FSC a Cover Pool monitor to monitor the eligibility of the Cover Pool independently. The Cover Pool monitor shall be (i) a person who qualifies as a bond administrator under the Korean Commercial Code, (ii) KHFC (excluding the case where the issuer is KHFC) or (iii) a corporation with equity capital of KRW 1 billion or more that has five or more administration personnel necessary for the performance of duties as a Cover Pool monitor including two or more experts such as lawyers, certified

public accountants or certified public appraisers and one or more persons with experience in business related to Covered Bonds.

The Cover Pool monitor is authorised to take any actions in court or otherwise necessary for the management, maintenance and disposition of the Cover Pool. The Cover Pool monitor is obligated to submit on a quarterly basis a report to the FSC within 30 days of the end of each quarter on the performance of its duty as a Cover Pool monitor and provide it to the issuer and, upon request, the Covered Bond investors and other parties, as described below, who have a priority right of payment from the registered Cover Pool.

## **VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS**

### **1. KHFC Act**

Articles 30 and 31 of the KHFC Act state that (i) KHFC may issue the KHFC Covered Bonds with a statutory priority right of payment over the mortgage loans separately managed in accordance with the applicable KHFC Act securitisation plan, and (ii) if mortgage loans in the KHFC Cover Pool are separately managed according to the applicable KHFC Act securitisation plan, the investors will have a priority right of payment against such mortgage loans unless otherwise prescribed in other laws. Considering the legislative intent and history of these provisions, the statutory priority right of payment over the mortgage loans owned by KHFC was considered as having been granted to the investors through the registration with the FSC of the applicable KHFC Act securitisation plan without taking any other actions necessary for the establishment or perfection of the statutory priority right.

KHFC is required to separately manage the mortgage loans included in the Cover Pool from its other assets on the basis of the applicable KHFC Act securitisation plan.

### **2. Covered Bond Act**

Article 13 of the Covered Bond Act states that (i) holders of Covered Bonds, (ii) swap providers, (iii) claim-holders relating to the redemption/maintenance and management of the Covered Bonds and management/disposal and execution of the Cover Pool, and (iv) the Cover Pool monitor have a priority right of payment on the registered Cover Pool over third parties. Article 12 of the Covered Bond Act states that, in case of an issuer's insolvency, the Cover Pool shall not be subject to the issuer's insolvency proceedings, including compulsory execution, preservative measures and stay orders. If the principal of the Covered Bonds is not fully repaid, Covered Bond holders have the right to payment from other assets of the issuer in addition to the Cover Pool. With the consent of the holders of at least 75% of the aggregate outstanding principal amount of the Covered Bonds, FSC may issue an order to transfer relevant contracts to another eligible issuer.

The issuer is required to separately manage the mortgage loans included in a Cover Pool from its other assets on the basis of the applicable issuance plan. The books for the Cover Pool must also be separately maintained and any violation may be subject to criminal sanctions.

## **IX. RISK-WEIGHTING AND COMPLIANCE WITH EUROPEAN REGULATION**

The Covered Bonds under the Covered Bond Act and the KHFC Covered Bonds under the KHFC Act are not compliant with Article 52(4) UCITS, in which case they may not benefit from the higher investment limits because neither KHFC nor any of the potential South Korean issuers of the covered bonds is a credit institution with its registered office in a EU member state. These covered bonds cannot be CRD compliant without meeting the requirements of Article 52(4) UCITS.<sup>1</sup> Thus, the covered bonds cannot benefit from special treatment in terms of risk weighting.

<sup>1</sup> Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): <https://hyppo.org/ecbc/covered-bonds/>.

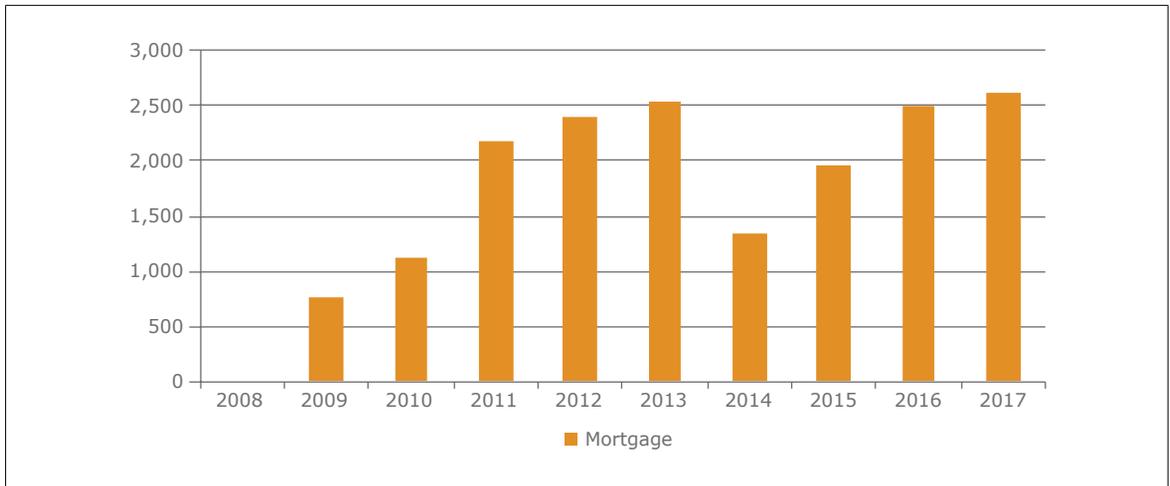
## X. ADDITIONAL INFORMATION

There have been 15 covered bond issuances by Korean issuers, nine of which were offshore issuances of foreign currency denominated covered bonds. To date, Kookmin Bank and KHFC are the only two issuers of covered bonds in Korea.

Issuer	Issue Date	Face Amount	Credit Rating	Market
Kookmin Bank	May 14, 2009	US\$ 1 billion	AA/Aa2 (S&P/Moody's)	Offshore
	October 21, 2015	US\$ 500 million	AAA/Aaa (Fitch/Moody's)	Offshore
	February 3, 2016	US\$ 500 million	AAA/Aaa (Fitch/Moody's)	Offshore
KHFC	July 15, 2010	US\$ 500 million	Aa3 (Moody's)	Offshore
	April 28, 2011	US\$ 200 million	AAA (NICE/KIS)	Onshore
	June 17, 2011	KRW 250 billion	AAA (KR)	Onshore
	July 25, 2011	US\$ 500 million	Aa3 (Moody's)	Offshore
	December 8, 2011	KRW 290 billion	AAA (KR)	Onshore
	December 29, 2011	KRW 250 billion	AAA (KR)	Onshore
	March 30, 2012	KRW 250 billion	AAA (KIS)	Onshore
	March 7, 2013	US\$ 500 million	Aa1 (Moody's)	Offshore
	March 7, 2013	KRW 150 billion	AAA (KIS)	Onshore
	November 19, 2015	US\$ 500 million	Aa1 (Moody's)	Offshore
	October 11, 2016	US\$ 500 million	Aa1 (Moody's)	Offshore
	October 25, 2017	US\$ 500 million	Aa1 (Moody's)	Offshore

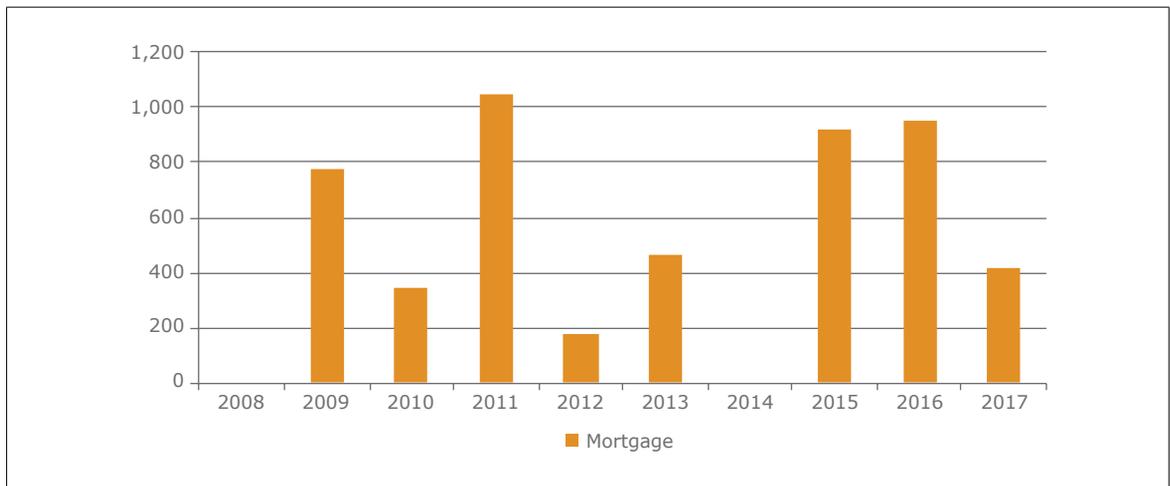
Source: Kookmin Bank and KHFC

> FIGURE 2: COVERED BONDS OUTSTANDING, 2008-2017, EUR M



Source: EMF-ECBC

> FIGURE 3: COVERED BONDS ISSUANCE, 2008-2017, EUR M



Source: EMF-ECBC

**Issuers:** Korea Housing Finance Corporation and Kookmin Bank.

**ECBC Covered Bond Comparative Database:** [http://www.ecbc.eu/framework/107/South\\_Korean\\_Covered\\_Bonds](http://www.ecbc.eu/framework/107/South_Korean_Covered_Bonds).