Market Failure and Effective Financial Consumer Protection in Korea

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Gyoung-Gyu Choi**

Abstract

Since the global financial crisis in 2008, many countries including Korea have introduced regulatory reforms to the financial sector and measures to protect consumers. This paper examines the effectiveness of proposed regulations in Korea, specifically the regulation of sales activity and screening addressed in the principles of suitability, adequacy, and the duty of clear explanation among others. For this, we have reviewed two cases in Korea: the KIKO options case and the Woori Power Income Fund case. In both cases, such regulatory measures provided little protection before or remedy following their respective financial debacles. In the KIKO case, many were quick to challenge the fairness of the contracts sold to consumers for this particularly sophisticated product, and apportioned blame on the option sellers for the financial fallout. However, under existing standards it is very difficult to demonstrate incomplete sales behavior and effectively prosecute sellers, despite staggering consumer losses. We argue that in both the KIKO and Woori Power Income cases, consumers tried to maximize their utility under the given circumstances. However a combination of factors including asymmetry of information, lack of financial knowledge on the part of consumers, and the towering market power of big financial institutions have led to what can only be described as market failure in financial consumer markets. Considering models of behavioral economics under market failure conditions, we suggest that an independent advisory services approach such as that recently introduced in the Korean legislature is more likely to be effective compared to the addition of further regulations on sales activities and mandated disclosures.

Key words: Financial Consumer Protection, Duty to explain, Suitability Principle, KIKO, Market Failure, ELS, Advisory Services

JEL Classification: 

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I. Introduction

Since the 2008 global financial crisis, interest in financial consumer protection has increased dramatically. Fallout from the crisis has encouraged a program of reform to tighten supervision and oversight of avaricious financial institutions. Many countries have taken measures to increase financial protections for consumers. Following the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 in the United States and the Financial Services Act of 2012 in the United Kingdom, discussions on financial consumer protections have begun to gain traction worldwide. The government legislative bill and the congressmen bills on financial consumer protection have been proposed since 2011, however, they have not been enacted yet.

In the absence of general laws for financial consumer protection, legislators have introduced individual laws that include regulatory measures for consumer protection such as the Banking Act, the Capital Markets Act, and the Insurance Business Act. However, this patchwork approach does not seem to provide effective consumer protection given the sophistication of today's financial products. Given that consumers seem to neither understand such products nor know how to manage their risks, today's financial consumer protection in Korea does not provide sufficient protection in the sales process or remedy arena for claimants.

This article is an attempt to evaluate current and proposed legal remedies to consumer financial protection issues in Korea. Among the various regulations involved, the paper focuses on sales activity regulations. For this, we examine two cases in Korea: the case of KIKO (Knock-In, Knock-Out) currency option contracts and the Woori Power-income Fund (Equity-Linked Securities) case.

Our discussion considers whether financial protection issues are due to market failures in Korea, and whether the proposed Financial Consumer Protection bills could correct these failures to
improve efficiencies. Also we discuss the direction for effective financial consumer protection in Korea.

II. The Two Cases in Korea

1. KIKO forward contracts

1.1. Overview
Between 2006 and 2007, scores of export-oriented Korean companies entered into what are known as KIKO (knock-in, knock-out) target forward contracts to hedge against an appreciating Korean Won. KIKO contracts are a combination of two derivative option conditions: a knock-out put option that terminates when a knock-out event occurs, and a knock-in call option that comes into existence when a knock-in event takes place. As described in Khil and Suh (2010), in the KIKO contract, two barrier conditions are imposed. The low barrier (L) defines the knock-out event for the KIKO contract termination, and the high barrier (H) defines the knock-in event for the call option to arise. In this way KIKO purchasers can sell foreign currency at a higher rate than the spot rate so long as the currency exchange rate remains above a certain knock-out (L) level. Rather than paying an option premium to the bank, the purchaser sells to the bank the call option guaranteeing to sell the currency to the bank at a level below the spot rate if the spot rate trades at above or equal to the knock-in rate (H) before the expiration of the option. For the purchaser, the KIKO allows them to hedge currency risk without incurring direct costs so long as the currency rate remains between the knock in and knock out levels (H and L).

Figure 1 illustrates the payoff of a KIKO when L = 885, K = 950, H = 965; compared with the payoff of an FX forward contract with the forward exchange rate (F) of 925. The KIKO has a relative advantage over the FX forward contract when the KRW exchange rate moves within a limited range between 885 and 965. However, if the exchange rate touches the low knock-out barrier level, then the KIKO provides a payoff of zero. Furthermore, if the currency depreciates (i.e. the exchange rate increases) and triggers the high knock-in barrier, the payoff of the KIKO deteriorates faster than that of the forward contract. As explained above, the KIKO options cease

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to be hedging instruments when either the knock-in or knock-out barrier is triggered. And in this sense the KIKO options contract should only be considered a partial or semi-hedging instrument. Because of this feature, the option holders need to continuously assess and manage exchange rate risks.

Unfortunately for these exporting companies, the Korean Won depreciated significantly against the Dollar in 2008 following the global financial meltdown, exposing KIKO contract buyers to big financial losses to such an extent that some companies were forced to file for bankruptcy. It has been alleged that several hundred apparently healthy small and medium enterprises (SMEs) fell into insolvency due to potentially inappropriate financial sales activities related to this KIKO options disaster. The total losses were estimated to be over 3 trillion won.

<table>
<thead>
<tr>
<th></th>
<th>Number of firms</th>
<th>percentage</th>
<th>Losses(Won)</th>
<th>percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large firms</td>
<td>46</td>
<td>8.9%</td>
<td>958.8 billion</td>
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<td>SMEs</td>
<td>471</td>
<td>91.9%</td>
<td>2.4 trillion</td>
<td>71.6%</td>
</tr>
<tr>
<td>Total</td>
<td>517</td>
<td>100.0%</td>
<td>3.3 trillion</td>
<td>100.0%</td>
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</table>

Source: Financial Supervisory Service

1.2. Were the contracts fair?
Although the KIKO contracts were regarded as hedging contracts by the exporting firms when they were traded, they were in fact more of a combination of hedging and speculation contracts in terms of their structure and effect. The allegation of the exporters in this context was that banks deceived them regarding the nature of the risk of KIKO option contracts, fraudulently induced them to sign the KIKO contracts, and included in the contracts terms that were inherently unfair and disadvantageous to KIKO buyer. The complainants argue that the KIKO contracts should therefore be voided or voidable.

The fundamental point on which the claimant's case rested was consideration of the KIKO contracts as standard-form contracts under Korean law. A standard-form contract is one where one party sets the terms, and the other party cannot negotiate terms but can take or leave the contract as is. Standard-form contract law includes provisions for determining the fairness of contracts, as well as proscribing certain kinds of terms and conditions that can be proved as unfair to one party.
In a KIKO contract, some provisions are standard, however other key provisions such as the contract period, knock-in rate, knock-out rate, exercise exchange rate, and leverage are determined and negotiated on an individual customer basis. In response to the accusation, then, the banks argued that these provisions taken together do not constitute pre-determined contract and so are not subject to the Standardized Contracts Act.

Answering the fairness case more broadly, banks argued that KIKO option trading was not unfair considering the following: (i) the contractual conditions are not unfavorable to customers because they are designed for both banks and customers to hold the same option value (ii) if a customer performs an option trade within its dollar position, it would obtain profits in dollars in kind even if there was a rise in the exchange rate, so the loss incurred by the customer does not result from KIKO trading itself but from over-hedging, and (iii) KIKO option trading is commonly used both in domestic and overseas markets.

The Korea Fair Trade Commission accepted most of these assertions and ruled in 2008 that the terms and conditions of KIKO options contracts are not unfair under the Standardized Contracts Act⁴. Further strengthening the position of the banks, the Seoul Central District Courts found KIKO agreements to be neither unfair nor fraudulent in nearly 140 different cases brought before then in 2010, and the Seoul High Court ruled in 2011 that KIKO agreements are valid.⁵ In their decision, the Seoul High Court pointed out that export companies, which regularly engage in foreign exchange-related business transactions and who are constantly exposed to foreign exchange risks, may have difficulty effectively arguing that they are simply victims of a fraud or unconscionable contracts. Finally on September 26, 2013 the Supreme Court of Korea made four decisions on KIKO cases. The main holding was that KIKO contracts were adequate for hedging and therefore not speculative. Regarding the self-responsibility principle, the Supreme Court concluded that plaintiffs (the export companies) held more responsibility than the defendants (banks) in these cases. Many studies criticized the Supreme Court for siding with the banks rather than financial consumers.⁶ Especially Kim(2014) criticized the decisions of the Supreme Court as he participated in the public forum debate in the Court on July 18, 2013 as a professional witness.

Academics have since considered the adequacy of these rulings from a financial perspective

⁵ Seoul High Court Decision No. 2010Na34519, May 31, 2011.
rather than the application of law. Khil and Suh (2009) investigated pricing on KIKO option contracts resulting in losses and found that risk management failures are a more important factor contributing to losses than possible mispricing, with little evidence of significant overpricing.

Despite the courts' decisions, KIKO contracts are complicated structured products demanding sophisticated risk management on behalf of purchasers. The financial analysis of whether they were overpriced or underpriced by banks, or the actual financial cost related to their purchase and servicing may be beyond the realm of strict legal interpretation. Therefore despite these clear court judgments, KIKO disputes continue to be brought before the courts7.

1.3. Did the banks explain the risks?

If there were not inherent problems with the contract itself, the next question is whether the banks explained the characteristics of the product and contract terms enough for the firms to make rational choices. The first is the duty regarding suitability and appropriateness of financial products that a bank recommends; and the other is the duty to explain products so that the customer can make a reasonable decision. In Korea, the duty to explain is designated in the “Financial Investment Services and Capital Markets Act” and the “Insurance Business Act” (See Table 2). The Capital Markets Act tries to provide standards for the duty to explain. In the case of KIKO contracts, interpreting this Act means that the bank must first explain the essential factors of the relevant derivatives, and receive written confirmation of the investor's understanding. Second, the bank is not required to explain the purchasing business's margin requirements. Third, the bank must explain exactly and understandably the nature of the knock-in and knock-in clauses, the period, and other unique features. Finally, the potential upsides and downsides of such foreign exchange rate-related products must be explained.8

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7 In 2013, Simmtech, a Korean electronic parts maker, filed a $73-million damage suit against Citigroup's six US affiliates including Citibank regarding KIKO currency options. In 2016, a U.S. appeals court allowed a Korean company to file a lawsuit against Citibank over a foreign exchange derivative, opening the door for the local exporter to claim $73 million from the U.S. bank.

8“Financial Investment Services and Capital Market Act” Article 47 (1) A financial investment business entity shall, whenever it makes an investment recommendation to an ordinary investor, explain the details of the financial investment instrument, the risks contingent upon the investment, and other matters specified by Presidential Decree with such sufficiency as to allow the ordinary investor to understand them. (2) A financial investment business entity shall, whenever it makes an investment recommendation to an ordinary investor, explain the details of the financial investment instrument, the risks contingent upon the investment, and other matters specified by Presidential Decree with such sufficiency as to allow the ordinary investor to understand them. 3) No financial investment business entity shall, when it provides an explanation under paragraph, provide false or distorted information (referring to an act of providing a conclusive judgment on an uncertain matter, or information that is likely to mislead an investor to believe any uncertain matter to be certain) while explaining material facts that may produce a significant impact on the investor's reasonable judgment or the value of the relevant financial investment instrument (hereinafter referred to as "material facts") or omit an explanation of any of the material facts.
Even though the duty to explain is included in the Capital Markets Act, there is still confusion regarding the scope of the duty in practice, and some may consider the scope and duty as specific to different investors given investors' varying levels of product knowledge and information. In other words, the extent of explanation might be different according to the particular customer. Choi (2013) argues that the appropriate degree of explanation should be determined by however much information is required so the investor can make a reasonable decision. Pointing out that providing necessary and sufficient information might mean that financial investment firms need to explain “to the degree that the investors’ understanding is equal to their understanding,” Choi (2013) suggests that it is necessary to distinguish external variables like exchange rate fluctuations from the content of the financial product itself, and that the experience and liability of investors should be considered deeply when recommending products. Yang (2015) criticizes banks for not disclosing the particular risk structure of the KIKOs for exporting firms not accustomed to speculation in this regard, and finds the Court decisions on fairness therefore wanting.

With regards to the banks' responsibility to explain, the Seoul Central District Court found more favorably towards the export companies. In a 2010 ruling the courts found that the banks failed to fully explain the KIKO agreements to customers in 91 cases involving 118 companies. In 19 cases, they found the banks partially responsible for losses. Companies and legal scholars claimed that the banks not only failed to explain the agreements fully and understandably, but also deceived companies by describing KIKOs as "zero-cost" products, this despite charging sizable fees for them. Kim & Park (2013) discussed the decisions of the lower courts on the KIKO cases in detail regarding duty to explain and the suitability principle and raised questions about the decisions.9

In 2013, The Korean Supreme Court also confirmed that banks must disclose relevant information regarding financial instruments so that the customer can rationally decide whether or not to buy a product, yet stopped short of requiring that banks disclose their particular financial algorithms for calculating their own related risk and margins in KIKO contracts.10

This ruling seemingly allows for banks to take advantage of KIKO buyers or at minimum structurally advantage themselves in the design of the product terms, given banks' significant

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9 Evaluating that the decisions were not proper, they expected that Supreme Court of Korea will make a right decision with regard to the fiduciary duty. Kim & Park (2013), p.190.

10 For details on the decisions of the Korean Supreme Court, Choi, Moonhee (2014), “Banks’ Duty of Disclosure on Structure of the OTC Derivatives in Korean KIKO Case”, BFL. No. 64.


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11 Korea Banking Institute, Financial Consumer Protection, 2014, p. 28
wealth of performance data and analysis capacity compared to the typical purchaser. In this way the court's ruling deviates from the position taken by Choi (2013) that equal information and decision making capacity should be shared, and supports Yang's (2015) contention that the Capital Markets Act does not sufficiently define what the duty to explain means in practice. From the economics point of view, however, the duty to explain if read quite broadly precludes banks from optimizing their position. Banks are clearly not required to explain to businesses the businesses' requirements for risk management. Does the duty to explain then require the banks to explain to customers the banks' business risk management and justifications beyond the terms of the product, the nature of the instrument, and the risks thereof? Such questions are complicated by the nature of the financial market for such products and services. When markets are competitive, customers will punish banks with sales practices they feel are deceptive or who they feel insufficiently explain. However, in financial markets where several major banks have skewed market power, where customers have varying levels of knowledge and information, and where the laws regarding duty to explain lack definition especially in the context of sophisticated products that are naturally constructed to favor banks, there is little that factual evidence can do to remedy disaster. To paraphrase, customers may not know what they do not know. And therefore full explanation is an ambiguous business.

1.4. Were the contracts suitable to exporting firms?

With regards to the sale of financial products, the principle of suitability of a particular product for a customer, along with the duty of explanation, is a basic protection. The principle of suitability applies to the sale of nearly all financial products. Suitability is to ensure that consumers are not sold products that are inappropriate given the customer's level of investment knowledge, their financial status, and investment experience. It places the responsibility for ensuring such appropriate knowledge, expertise, and experience on the shoulders of the banks, and is therefore one of the industry's great conflicts of interest.

12 Financial Investment Services and Capital Market Actm Article 46 (1) Each financial investment business entity shall confirm whether an investor is an ordinary investor or a professional investor. (2) Each financial investment business entity shall obtain information about the investment purpose, status of property, experience in investment, etc. of an ordinary investor through interviews, inquiries, etc before recommending him/her to make an investment; and shall require the ordinary investor to make a signature (including a digital signature under subparagraph 2 of Article 2 of the Digital Signature Act; here in after the same shall apply), print his/her name and affix his/her seal, record conversations, or have a confirmation in any other manner specified by Presidential Decree, and keep and maintain the confirmation safely, and shall furnish the investor with the confirmed information without delay. (3) No financial investment business entity shall recommend an ordinary investor to make an investment, if the investment is deemed unsuitable for the investor in light of the investment purpose, status of property, experience in investment, etc. of the investor
As mentioned above, the KIKO options cease to be hedging instruments when either the knock-in or knock-out barrier is triggered, and in this sense the KIKO options should only be considered as partial or semi-hedging instruments. Companies tried to use the KIKO to hedge their exchange rate risk, but the put option price in KIKOs is not explicit and fixed like a typical hedging instrument. Instead, the "price" of the options is providing a call option to the banks. In this way, it is a semi-hedging instrument. In fact, this call option term itself could, under volatile circumstances, force firms to file for bankruptcy in order to fulfill it, as was the case with many Korean firms.

Given this downside, are KIKO contracts suitable for exporting firms at all? If not, then why did the firms purchase KIKOs in such large numbers? Kim & Kim (2009) and Jun(2010) point out that KIKO contracts are not suitable for these firms considering the nature of the derivatives. Seong (2016) also argues that KIKO contracts are not suitable to small exporting firms, contending that the banks are partially in violation of the suitability principle in such cases. Indeed, Park (2010), Kim (2013), Lim (2014), and Kang(2014) each also point out that in many cases the Court rulings failed to find violations on the suitability principle of KIKO contracts. However, Kim(2009), an economist, argued that the structure of KIKO designed for hedging with no payment and was a proper financial instruments for small firms. This is in line with Khil & Suh(2009) that the KIKO contract itself is not unfair and the loss was mainly from risk management failure.

From the banks' perspective, the options contract operated more like insurance, because the maximum loss was pre-determined by the knock-out barrier (in contrast to the position of firms for whom there is no cap to their potential loss due to the knock-in option being called). Such insurance against market volatility is a common and understandable position for banks to take, despite the infrequency of such major crises. The premium of such insurance in KIKOs is the put options of the purchaser. Clearly exporting firms along with a great number of investors worldwide could not anticipate the kind of exchange rate volatility resulting from an unanticipated global financial crisis. Indeed, KIKO contracts are a kind of expectation competition between banks and customers anticipating exchange rate movements. The nature of KIKOs for purchasers

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13 For an argument that KIKO contracts are a mistake for exporters, see Park (2010).


15 Kim(2009) argued that one cannot argue for the validity of contracts only because the price changed suddenly contrary to expectations and the loss was over-estimated because it was evaluated in an accounting period.
is therefore speculating, not truly hedging, and customers are outgunned in this competition by the information and analytical capacity of the banks, even if the contracts are valid and the products priced fairly. So if the interest of the export companies was hedging, not market speculation, then the KIKO is by nature an inappropriate product.

However, Ko (2010) disagrees with this assessment based on the fact that the purchaser can trade their spot position in the case of over hedging resulting in no loss to the company. He concludes that the products are not, therefore, unsuitable for exporting firms. He also concludes that, from a pricing perspective, the KIKO products are not unsuitable nor unfavorable to enterprises in that the premiums for the put option and the call option are not so disparate unless the margin and other costs are excessive. Yet the issue seem to arise when firms buy the KIKO to ‘hedge and forget’, not actively managing the product ongoing. In these cases it is not rational for firms to carry a large spot position in preparation for a sharp depreciation of the won.

If, as some content, the KIKOs is a suitable albeit part-speculative product for small size export companies, then surely it can be considered suitable for larger enterprises with far more resources to analyze and manage such an investment? Yet not many large enterprises did not purchase KIKOs. Whether or not banks' foresaw and intentionally exploited a particular Achilles Heel of SMEs, the focus of purchase by the particular segment and not by others with more analytical and risk management resources suggests that the sophisticated KIKO is unsuitable for small and medium enterprises. But again this contention is not easy to prove, as a multitude of factors contribute to the attractiveness of financial products to one segment or another, and the Won/Dollar exchange rate had up to the crisis remained quite stable.

2. Woori Power Income Fund case

2.1. Overview

Commencing in 2005, Woori Bank marketed and sold to customers in Korea an investment fund product known as the “Woori Power Income Fund,” created and managed by Woori Credit Suisse Asset Management. The Woori Power Income Fund is an OTC derivative similar to Equity-linked securities (ELS) in structure. ELSs are hybrid debt securities whose return is connected to an underlying equity (usually a stock). Equity-linked securities can be in the form of a single stock, a group of stocks or an equity-based index, such as the S&P 500. ELSs normally
pay a higher yield than the underlying security and generally mature in one year. The return on 
investment is dependent upon the performance of the underlying equities that are linked to the 
security. ELS derivatives are designed to give a high return to investors if the share price of their 
underlying assets does not fall under a preset level. Therefore it is natural that sellers of such 
products hope that share prices fall before they reach maturity.

Woori Power Income Derivatives Investment Trust 1 was an open-end fund incorporated in 
South Korea. The Fund invests 70% or more in OTC derivatives linked to price volatility of more 
than 100 overseas securities listed in Japan, US, Canada, and Australia, and 30% or less in bonds, 
ABs, and CPs, respectively.

In 2005, Woori Asset Management and its affiliates (Woori bank, Kyungnam bank, etc) sold 
the Woori Power Income Fund to the public. Even though the fund was very complicated and 
difficult to understand, Woori either publicized the fund as being very safe, as safe as Korean 
government bonds, or sold it to the general public without any specific explanation as to the risk 
of losing their principal investment. After all, the Fund invested in safe assets (credit ratings of 
A3 or equivalent) and paid a fixed income on a quarterly basis. The advertisement also 
emphasized that the fund was suitable for retirees and those who needed a fixed return on a regular 
 basis. It was marketed by both commercial and regional banks as having U.S. and European blue 
chip stocks as underlying assets, with a promised return rate of a stable 6.7 percent per annum 
every three months. The Woori-Power income Fund had gathered more than 170 billion won from 
more than 2200 investors who needed safe investments. In truth, the product consisted of 
derivatives that would sustain major losses when underlying stocks prices fell below a certain 
level. Unsurprisingly, its return rate was decimated in the wake of the 2008 financial crisis. The 
Fund recorded a phenomenal loss of 97.5%.

2.2. Violation of duty to explain and suitability principle

In the Woori case, the financial instrument customers were primarily individuals rather than 
 firms, and their limited understanding was that the fund investment was a kind of high return 
 deposit instrument with no risk to their principle. Such products were commonly sold by large 
national banks like Woori in Korea, and principle-risking complex fund investment products were 
the exception. In the case of the Woori Power Income Fund, the product risks were even greater 
than a typical ELS investment.

Normally ELS funds are designed to recover their value as stock prices recover, even after the
underlying stock prices go below an option barrier. But the Woori Power Income Fund was designed so that it was impossible to recover its value once the underlying stocks fell to a low credit rating band and remained there for a certain pre-determined amount of time. During the financial crises of 2008, the funds lost most of its value and could not recover because of this structural peculiarity. The full losses of buyers would have been realized at maturity in 2011.

Investors argued that the Fund was fraudulently advertised and miss-sold to investors given that the customers believed the product to be "safe" and their profile was risk-averse.

In the end, the Financial Supervisory Service decided that Woori Bank and other sellers of the Woori Power Income Fund should compensate 50 percent of the losses to investors applying for indemnity. However, the Korean Supreme Court contradicted this ruling and decided that the banks are responsible for less than 40%. During this period of market volatility and financial product diversification, consumers have had to learn the expensive lesson that depository national banks can and do sell risky financial instruments. Not only is there ambiguity in the awards for settlement between courts, but the low awards compared to losses seems to point to the need for new protection regulations.

The duty to explain can be legally evaluated as an intentional omission of important information on purpose or with recklessness (a violation) or as the supply of incorrect or misleading information (fraud). In the latter case, the claimant only needs to supply proof of the incorrect or misleading information. In the former case, it is not as easy to determine especially in the case where the buyer or/seller do not have enough knowledge to understand the complicated structure of the financial products themselves. In Korea, it is not uncommon that the seller does not understand exactly what they are selling. This brings us to the next question: is the designation of a product as "safe" sufficient "understanding" for a purchase? Or should financial institutions sell ELSs only to customers who have a proper financial understanding of CDOs? What if the general customer wants to purchase complicated financial instruments anyway, despite inexperience and lack of understanding? Do banks in this case have a duty to discourage or prohibit sales to customers where the customer does not understand the underlying financial instruments? How can the financial institutions adequately evaluate and record the level of

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16 In 2011, the compensation was settled at 2.03 billion won by the high court in 2011 for the lawsuits by eighty-seven investors of Woori Power Income Fund initially claiming of 2.9 billion won, but the 70 percent is the highest compensation ruled by a court on fund sellers or asset management firms. The previously highest compensation was 40 percent. The compensation was settled at 2.03 billion (70%) won by the high court in 2011.
knowledge of a customer, given today's rapid product innovation?

About the duty to explain, if the banks provided ‘wrong’ information to the customers, and if the customers can prove the ‘fact’ of fraud, the compensation would be easy. However it is not always obvious again to prove what is ‘wrong’. And normally the facts for proof are kept by the sellers.

2.3. Market failure

Market failure arises when both parties try to maximize their utility/profit under unique constraints, and the transaction results in inefficient outcomes for both parties. Even though banks provided proper information about the risk characteristics of the funds, there were reasons that investors chose the Woori Power Income Fund in 2005. In Korea, the interest rates of deposit banks were very low while the securities markets showed strong performance. Since 2003, the KOSPI demonstrated a strong upward trend (See Figure 1). Investors badly needed financial instruments other than deposits for higher returns. And the investors may have concluded that the strong market trend would continue with the Asian Financial Crisis so many years in the past. In these circumstances, even though the banks explained the risks, it might not have changed the minds of investors, because they wanted financial instruments with safety and high returns. Their lack of understanding might therefore not have affected their decision, which could be considered both ill-informed and, from a speculators perspective, rational at the same time. In this way their perspective mirrors that of the KIKO purchasers.

<Figure 2> Kospi(2003-2006)
In this age of financial engineering, the market for more complex and diverse products like ELSs has exploded. In the case of ELSs, pricing fairness has come under scrutiny as have charges of stock price manipulation, as the profit/loss structure of the product is determined by the stock's closing price on a predetermined day. Um (2013) suggests that there must be additional means to ensure the fair price of underlying stocks and trading activities to improve the regulation of ELSs. Chung and Ahn (2013) propose several points to ensure consumer protection in ELS transactions, and Lee (2010) argues that there should be a reasonable determination by supervisory authorities regarding the relationship between valid ELS products with delta hedging transactions and abusive hedging transactions. However under the increasing asymmetry of information and knowledge, there is clearly more room for sellers to maximize their profits against customers, whose only recourse is through the courts where those ruling as well as the supervisory authorities have failed to keep pace.

III. Market Failure and Market Efficiency

1. Risk averse utility function and maximization

The discussions on KIKO have been focused on the fairness of the contract or whether the banks violated standard rules regarding sales activities, rather than the effective functioning of the market. In this article, we would like to examine these cases from the point of social welfare and market function. For example, in the case of the KIKO contracts, the exporting firms intended to avoid uncapped losses due to exchange rate volatility but exchanged it for uncapped losses due to the call option giving to the banks. The KIKO contract was a rational choice for the firm given their expectation of a steady or mildly decreasing Won/Dollar exchange rate over the contract period, but irrational given that small firms should have high risk aversion and avoid a half hedging-half speculation contract that requires active and knowledgeable management.

Ko (2012, p. 398) contextualizes the firms' decisions as economically rational, stating that "...given the forecasts of many research institutions predicting the Won's stabilization or slight appreciation, it seems reasonable for these companies not to enter into the standard hedging contracts and instead to opt for the KIKO contract since the standard contract would require payment of a higher premium. Moreover, since forecasts by credible actors typically have a
significant impact on consumer confidence and on the overall market, it was reasonable for these export companies to make decisions based on the predictions of major research institutions.” So from a pricing perspective, the decision was rational. But what about from a risk profile perspective?

Small and medium export firms are particularly susceptible to financial market movements, which is why such firms may have been interested in the hedging aspect of the KIKO product in the first place. Yet due to their limited resources and market power, such firms should also be risk-averse. Given the uncapped risk nature of the KIKO product, it suggests that such firms were not aware they of their own risk-aversion (since maximizing their risk averse utility function would turn them away from the KIKO purchase), were not aware of the uncapped risk nature of the call option part of the contract, or both. In any case, these conditions do not absolve the firms of responsibility. In other words, the considerations of the courts and academics are moot in light of the lack of understanding.

In summary, the court rulings regarding the fairness of KIKO pricing and validity of KIKO contracts are perhaps secondary to the separate issue that supposedly risk-averse SMEs purchased a semi-speculative product in droves. The question of responsibility cannot be addressed in a product market where buyers and sellers may be ignorant. In such a scenario, market inefficiency should be expected.

These two points lead us to more fundamental questions. First, in this day and age of radical financial engineering, is it possible for firms to ever be suitably knowledgeable? Second, can regulations on sales activities and consumer protection legislation keep pace with let alone address issues when information asymmetry amongst all stakeholders is so extreme? Finally, how can the suitability and appropriateness principles and duty to explain be applied let alone verified with such mind-bogglingly complex products?

2. Market efficiency and deadweight loss

Given that there is evidence that both the banks and firms in the KIKO case had rational grounds for entering such contracts, it is instructive to examine the aspects of market failure in these markets. Market failures exist typically under conditions of information asymmetry, concentrated market power, and critical externalities. Market failures result in lower social welfare outcomes. When market failures exist, transactions in the market are over or under the optimum level causing deadweight loss in the market. In case of KIKOs, the volume of
transactions exceeded the optimum level (the number of actual risk-content customers) causing deadweight losses in the financial markets and manufacturing markets. Even if the decisions were ‘rational’, they were not optimal from the point of social welfare because those transactions brought about huge deadweight loss. Here we can say that the loss came from too many transactions than optimal. As long as there is gap in information and knowledge between financial institutions and the consumers, the financial markets are subject to market failures.

However if they knew better about the products and about the risks of the markets, and basic principles of financial investment, they might not have made other choices. This means that the losses of the two cases were not just because of their wrong expectations, but because of limited rationality with limited knowledge, and a gap in information and knowledge between financial institutions and the consumers. In principle, the deadweight loss could be reduced by government intervention or regulations. The next question is can financial regulations correct market failures and improve market efficiency in the financial markets?

3. Can consumer financial protection legislation prevent such disasters in future?

A new legislative bill has been proposed to build a framework for financial consumer protection that covers the whole process of financial consumption: providing prior-information, selling financial instruments, and post-remedies for damages.

In a 2011 press release, Korea's Financial Services Commission outlined the legislation. The main contents are first, to provide a substantial prior-information to consumers through financial education and comparative financial disclosures so that financial consumers are able to enhance their capacity to protect themselves from incomplete sales. Second, by establishing a tighter regulatory framework that prevents incomplete sales activities in the sales process for all types of financial instruments, the bill tries to regulate the sales activities of financial institutions. In addition, by introducing a public impost system, strong regulatory sanctions against violations have been included. Third, by strengthening the ability to restrict activities of financial institutions as a result of dispute resolution procedures, the bill intends to enhance the effectiveness of post-remedies for damages. Finally the legislative bill also proposes to build an independent financial consumer protection organization.

Rho (2015) pointed out the necessity for legislation has been considered from three perspectives. First, the current regulatory system enforced separately in each of the various financial sectors is insufficient to respond effectively to consumer protection requirements.
Individual laws such as the Banking Act, the Capital Markets Act, and the Insurance Business Act provide only piecemeal protection for consumers. Second, as a general law for financial consumer protection does not yet exist in Korea, there is no established vision or indeed no implementation strategies for the mid- and long-term policy horizon of financial consumer protection. Third, under the current organizational system of financial supervision, consumer protection functions and bodies are vulnerable. The Financial Supervisory Service (FSS) is in charge of both prudential supervision of financial institutions and consumer protection at the same time, creating the mechanism if not the significant problem of a conflict of interest (Kim, Jae Bum, 2013, pp. 7-8).

However, there are many limitations for pre-emptive measures but also in post-remedies to enact effective consumer financial protection legislation (Kwon, 2014), not to mention the regulations on sales activities in the bills were already in the separate acts. Reviewing the KIKO and Woori Power Income cases, it seems unlikely that a general law will stem such reoccurrence.

In the cases of OTC derivatives in other countries, there were cases that the courts applied the duty to explain and the suitability principle to sellers. Yun(2011) reviewed five cases related to OTC derivatives investment loss, including two Korean offshore funds' cases litigated in the U.S. (Diamond Fund case and Morning Glory Fund case), two U.S. cases (BT Securities(Gibson) case and P&G case), and one recent German Supreme Court case in March 2011. The German Supreme Court decided that the seller violated the duty to explain in the German CMS Spread Ladder case. Yun(2011) pointed out that the KIKO case is not basically different from the German case and the similar decisions are expected also in the Korea Supreme Court. However, the results were different in Korea.17

Although the bill proposes an independent financial consumer protection organization, it is not guaranteed that the organization would be really independent from the influences of big financial institutions. Given the complexity of current financial products sold to the general public, it is not simply a matter of information provision, but a question of wide-ranging financial expertise that purchasers require. Banks are not in the business of delivering in-depth financial education. Yesterday's rules for more simple financial instruments no longer apply. Furthermore, given that financial markets are oligopoly markets with concentrated market power, it is hard to expect that

17 Yun(2011), p.70. In the German case, the initial evaluation price was negative. However, in KIKO case, there are different opinions whether the price in the form of call options of the banks was valid or not.
the financial products are designed with the interests of consumers in mind. This means that the problem of market failure in the consumer financial market cannot be solved by a general law or through additional information, and supervisory bodies must be very careful not to reinforce the legal responsibility of buyers. This new marketplace demands a different kind of stakeholder, the independent financial advisor.

In addition to the adding regulations to sales activities, current legislation on financial consumer protection has introduced the establishment of new players in the consumer financial marketplace, independent financial advisors. Independent Financial Advisors, or IFAs as they are known in other parts of the world, provide a counterbalance to the market power of banks, and reduce the conflict of interest inherent in the sale of financial products. Currently in Korea some insurance agents also provide such advisory services on commission. However, as there is no regulatory framework yet the current system is vulnerable to abuse. In the proposed legislation, sales and consultations by the same financial institutions are partly allowed, while there are entry barriers to starting an IFA business. Most of all, if consumers have to pay a consultation fee for what they are accustomed to getting for free they might not opt for independent advice (Kwon, 2014).

IV. Conclusion

In this article, we have tried to examine the effectiveness of financial consumer protection in Korea by focusing on regulations regarding sales activities - specifically the duty to explain and principle of suitability - and their application in two significant cases of consumer losses. In both cases, the purchasers of complex financial products made what could be considered rational economic decisions at the time of purchases. We mean ‘rational’ in the sense that the choices might be best ones for investors under the limited information and circumstances. The KIKO contract were attractive to the small firms with limited knowledge on financial markets. The Woori Power Income Fund was also one of the alternatives who seek higher returns under the downward trends of deposit rates. And their decisions might be mainly based upon expectations of the markets, rather than the characteristics of financial instruments. Even if they heard the explanations on the risks from the sellers, they still might have entered contracts because the possibilities for the market to be reversed was thought to be very low then.

And it was hard for the investors to be compensated in Korea for their losses. Some issues of financial consumer protection such as pricing and risk-return structure of financial instruments
are beyond the legal discussions. And regarding sales activities, as we have noted in two cases in Korea, it is always not easy to find out ‘facts’ of violation. For the duty to explain, the responsibilities of proof are in the consumer’s side, but the evidences are in the hands of sellers. And the criteria for enough explanation are ambiguous and should be considered by individual cases. For the suitability principle, it can only be applied as ‘a principle’, because financial consumers are not homogeneous in the markets, therefore, decisions on the suitability are different according to buyers. Under the circumstances, it was very hard for the financial consumer to win the lawsuits on incomplete sales in Korea.

Given this kind of rationality leading to market failure under scenarios of complex engineered financial products, regulations using standard form of general information might not help in improving or strengthening financial consumer protection. More regulations for financial consumer protection might only add more self-responsibilities to the financial consumers, when what consumers really need are the criteria of decision for their individual cases and the selected information for the decisions. And an economist would not expected that the financial institutions tell their customers their true utility functions and sometimes advise against the seller’s profits. Moreover regulations might reduce financial transactions. Therefore more regulations in the bill of consumer financial protection could rather decrease than increase market efficiency. Current trends of financial consumer protection in the bills are based upon the idea that the consumers can be equal in understanding the financial instruments if more information is provided. In other words, they do not consider the basic facts in the markets, asymmetry of information and knowledge and market powers of financial institutions, which represent market failure in financial consumer’s market.

The bill on financial consumer protection introduced independent financial advisers (IFA) who may help financial consumers make rational choices. Qualitative information from independent financial advisers could prevent the financial consumer from fraud and incomplete sales. However how the consumers will get a really ‘independent’ and proper financial advisory remains to be solved.

In conclusion, we propose that the direction of legislation and regulations for consumer financial protection should be more focused on market efficiency criteria rather than on the violations of specific sales activities given the complex nature of financial instruments and the explosion of the financial engineering sector. In this sense introducing IFA is expected to increase market efficiencies by balancing the information power between banks and the customers.
Regarding the suitability principle, we could introduce the rewarding system according to consumer satisfaction so that the financial institutions that provide proper financial instruments to consumers are rewarded and those who make incomplete sales disappear from the markets. But again under the market powers of big banks, market failure still remains. After all, the sound and stable financial consumers are one of the basic ingredients for stability and development of financial markets.

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