Building up bonds

Tax and structural changes in the South Korean government bond market last year will likely result in a significant rise in liquidity in this market this year, so facilitating the use of more sophisticated trading strategies. By Nicholas de Boursac

In 2009, the Korean authorities implemented a few significant measures to make Korean government bonds – Korea Treasury Bonds (KTBs) and Monetary Stabilisation Bonds (MSBs) – more accessible and more attractive to foreign investors. They did this through three actions:

1) the exemption of withholding tax on income from investments by foreign investors in KTB and MSB was approved by the Korean Parliament in April 2009 and became effective shortly thereafter;

2) the first 'bridge' between the Korea Securities Depository (KSD) and an International Central Securities Depository (ICSD) was put in place in October 2009; and

3) in response to the global economic crisis, Korea implemented a stimulus plan that resulted in an increase in supply of government bonds and issuance volume rose from $216.7 billion in 2008 to $401 billion in 2009[1].

These measures are only the latest significant steps in an initiative that has been developed over the past several years, with the objective of improving the liquidity of the KTBs and MSBs. Previously, many foreign investors were unable to use the tax credits or tax treaties; the exemption from a 15.4% withholding tax levels the playing field for all foreign investors and, for many, increases the net yield. In the first six months after the exemption, there was a 30% increase in foreign holdings in KTBs (see graph 1, page 34).

As a result of a specific legislation, effective in January 2008, the establishment of a 'bridge' with KSD allows the ICSD to open multilevel omnibus accounts. As investors and global custodians establish these accounts, they will be able to hold KTBs and MSBs in ICSD subaccounts. Also, the Investor Registration Certificate (IRC) is no longer required for investments held through ICSD omnibus accounts. As a result, the settlement process between offshore parties could be simpler and allow settlement outside the Korean time zone. Moreover, KTBs and MSBs held at ICSDs can be used as collateral in international tripartite pools. And this will make it easier and cheaper to finance investments in KTBs and MSBs. Cross-border repos may also be easier to execute. Euroclear established its 'bridge' in October 2009 and Clearstream is understood to be working on establishing a similar service.

While there were some significant changes in 2009 that look set to further develop Korea's government bond markets, this process has been ongoing for some years. There are also other notable strengths for Korea. Its issuance process being well managed and disciplined, with a focus on fostering secondary market liquidity (the Korea government bond market for both KTBs and MSBs), has the third-best trading volumes in Asia ex-Japan with $1.35 trillion in 2009[2]).

Closing and re-issuing contributes to deeper on-the-run issues. The Ministry of Strategy and Finance is effective at communicating to foreign investors and actively seeks feedback. Other key regulators – the Financial Supervisory Commission, Bank of Korea and the Financial Supervisory Service – are well informed and proactive. The market is already relatively liquid, with tight spreads. The domestic settlement and depository services at KSD are smooth and efficient. KTB and MSB futures and options, as well as the domestic interest rate swap market and the won-denominated non-deliverable forward markets, are actively traded and liquid.

The domestic repo market is also growing fast and outstandings now average about $7.5 billion (see graph 2, page 34). The Korea Financial Investment Association (Kofia) has implemented a local-language master repo agreement, which is very close to the global master repurchase agreement.

While the Korean won is not fully transferable, foreign exchange control regulations have been amended so that, for some time now, the foreign exchange rules do not prohibit the purchase or sale of KTBs and MSBs – or associated hedging of bond positions. However, restrictions on foreigners borrowing more than 30 billion won ($15.9 million) still apply, but are expected to be lifted soon. The process to obtain an Investment Registration Certificate (for securities not held in ICSDs) has also been streamlined significantly, with much of the process available online. There is also a sizeable and growing domestic institutionalised savings sector comprising insurance companies, pension funds and mutual funds that invest in KTBs and MSBs. Moreover, there are no ownership limits for foreign investments in KTBs and MSBs.

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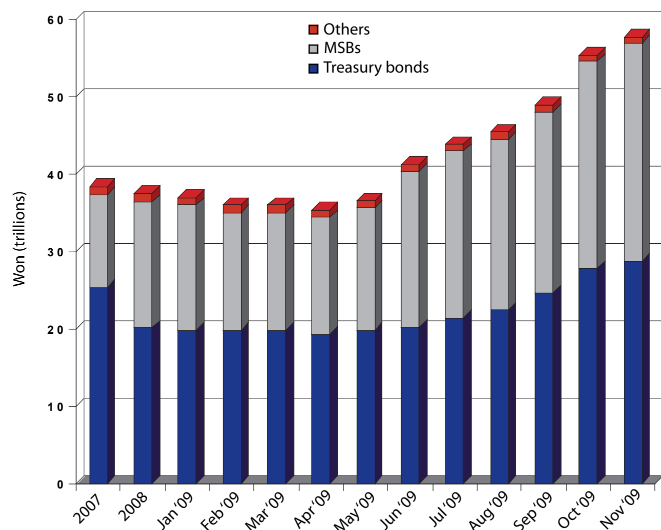
As liquidity improves, traders should be able to execute a full range of trading strategies in size and this looks set to improve as more reform is anticipated during the next 18 months or so.

Historically, foreign investors have held no more than 8% of out-

1 & 2. Source: AsianBondsOnline

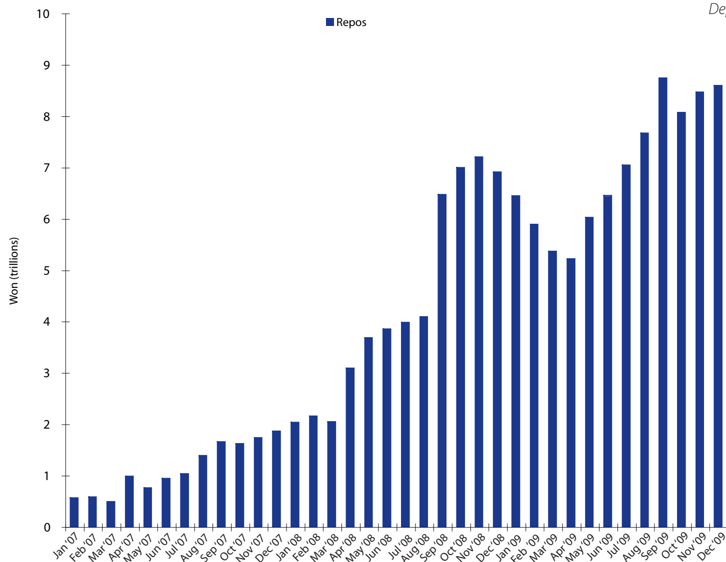
Graph 1: Foreign investors' listed bond holdings in Korea

Source: FSS



Graph 2: Outstanding balance Korea repo market

Source: Korea Securities Depository



standing KTBs, compared with more than 30% in the Korean equities market. The Asia Securities Industry and Financial Marets Association (Asifma) expects this to increase significantly, initially to as much as 20%. Foreign investments of this size will have a significant impact on the liquidity of the bonds. Furthermore, there is a high expectation KTBs will be included in Citi's World Government Bond Index (WGBI) during 2010, an index followed closely by many Japanese fixed-income managers. And an inclusion of Korea (probably with a weighting of 1.25%) would result in a significant flow of funds into KTBs, which would need to remain invested in KTBs unless Korea left the index.

Currently only local securities houses and primary dealers are allowed to take naked short positions as part of their market-making activity. But locally incorporated banks should be allowed to sell KTBs and MSBs short (naked or covered shorts), as this would allow non-primary dealer banks to quote more readily, since the banks would be able to run their books more easily and to trade as principals rather than brokers. Foreign investors would also be able to deal more fluidly with the banks they deal with globally.

The new ability for banks to go short would have an immediate impact on the liquidity of the repo market and therefore accelerate the growth of the domestic repo market. The bulk of the $30 billion call money market should also be 'transferred' to the repo market.

The bulk of the 30 billion call money market should also be 'transferred' to the repo market. (The call money market is an over-the-counter and unsecured market with 700 heterogeneous participants in Korea who lend each other cash overnight on a bi-lateral basis.) This could be driven by the regulators' need to reduce systemic risk as the call money market is unsecured. It may be achieved by restricting access to the call money market to banks. And the growth of an offshore repo market (as a result of the bridge between KSD and the ICSD), coupled with a growing domestic repo market, would further enhance liquidity.

The documentation requirements for foreign investors to obtain withholding tax exemption on income from their investments in KTBs and MSBs will hopefully become increasingly user-friendly and, in time, only a tax domicile, self-certification will be required. The Korean authorities pay continuous attention to issues raised by foreign investors and the market would support the implementation of regulatory changes to ensure smooth execution of transactions, for example dealing with the remaining constraints on advances of won to non-residents that impact the movement of funds associated with manufactured coupons in cross-border repos. KSD has informed Asifma it will change its methodology for handling the haircuts and margining in domestic repo transactions to bring them in line with global norms within the next 12 months.

Long term, the market would welcome evolutions such as the consolidation of the issuance of KTBs and MSBs so they are fungible. This would significantly improve liquidity as the two sizeable pools of liquidity would become one. The elimination of all foreign exchange control regulations may have limited practical applications, but would change foreign investor perception, as there is confusion regarding which regulations remain and their impact on investments. Also useful would be the redesigning of the 10-year KTB futures market to make it cash settled. And the market would also welcome the redesign of the inflation indexed government bond to make it more liquid as well as the evolution of the trading and price discovery platforms towards a system more consistent with global norms.

Any major changes such as the inclusion of KTBs in the WGBI, the announcement that banks can short (naked and covered) KTBs and MSBs along with the merging of the issuance of KTBs and MSBs, would likely result in a large increase in foreign investment in KTBs and MSBs and a significant improvement in liquidity. This would provide a deeper underlying market for derivatives. ●

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