Overview

A. Formation and Early Development of Bond Market in the Republic of Korea

The Government of the Republic of Korea issued its first bond, a National Foundation Bond, in 1950 to promote economic growth and finance post-war reconstruction. As market and economic conditions have changed over time, the bond market has intermittently seen dominance by either corporate bonds or government bonds such as Grain Bonds, Monetary Stabilization Bonds (MSBs), and Korea Treasury Bonds (KTBs), among others.

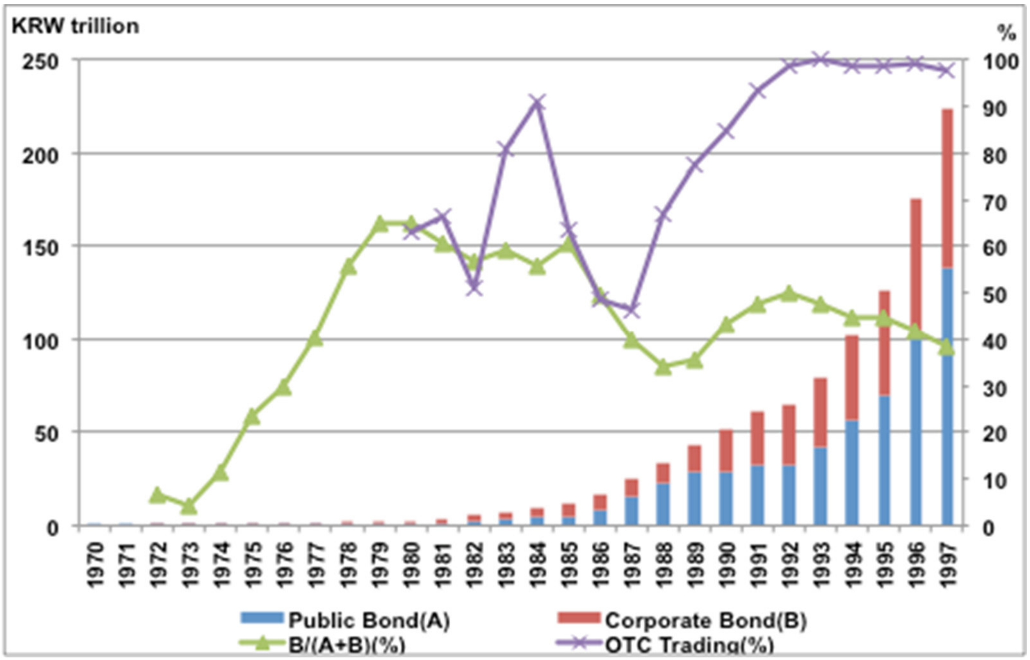
The issuance of National Foundation Bonds, which had led the bond market in the early 1950s, was subsequently suspended due to growth in the national debt and fiscal soundness concerns. In the late 1960s, government agencies and public institutions that had been established under special laws started to issue special bonds in their place.

The government, which was trying to raise private sector funds for economic development, put forward a capital market development plan at the same time. The Capital Market Promotion Act was enacted in November 1968, setting up a base for the formation and development of a market for publicly offered corporate bonds. The publicly offered corporate bond market, which was established in 1972, grew rapidly on the basis of (i) institutional support, including firm commitments, payment guarantees from financial institutions, and mandatory listing on a securities exchange; and (ii) policy measures for spurring demand such as the establishment of investment trust companies. Publicly offered corporate bonds dominated the bond market in the Republic of Korea until the mid-1980s.

As a result, corporate bond issuance, as measured by bonds listed on the securities exchange, rose from nearly KRW4.7 billion during the first year after its inception to KRW1,001.4 billion in 1979, accounting for 65% of total listed bonds outstanding at that time. Figure 1.1 shows the outstanding amount by bonds by type (public and corporate bonds), the proportion of corporate bonds, as well as the proportion of over-the-counter (OTC) trading in the market since the inception of the corporate bond market up until the 1997/98 Asian financial crisis.

A corresponding change also occurred in the secondary bond market. With the securities market at a nascent stage, the government strived to concentrate securities transactions on the exchange. OTC bond trading was prohibited by the Securities and Exchange Act of 1962. However, bonds were allowed to be traded in the OTC market in the 1970s when the rise in corporate bond issuance led to the introduction of repurchase agreements (repos) as a means of using corporate bonds as collateral to obtain financing. As not only repos but also bonds were actively traded in the OTC market, OTC trading became widespread practice. From the second half of the 1980s onward, OTC transactions were predominant in the secondary bond market.

Figure 1.1: Korean Bond Market Expansion Prior to the 1997/98 Asian Financial Crisis



Sources: Korea Exchange, Korea Financial Investment Association.

In the mid-1980s, concerns arose over inflation due to a pick-up in foreign capital inflows, which resulted from growth in the current account surplus and a subsequent increase in market liquidity. MSBs, which are short-term bonds designed to protect against inflation, showed a huge increase, reaching 69.4% of new government bond issues and 45.6% of total listed bonds and notes in 1998. MSBs effectively changed the structure of the bond market, which had been dominated by corporate bonds, and came to dominate the market.

However, as the current account surplus declined in the 1990s, the bond market again focused on corporate bonds. Guaranteed bonds continued to prevail in the corporate bond market, but guarantee providers were more diverse than before. Concurrently, Korean firms' growth, supported by the domestic economic expansion and their improved financial structure, led to an increase in the issuance of non-guaranteed corporate bonds. Furthermore, the bond market became more diverse with increased issuance of bonds with embedded options such as convertible bonds.

In the mid-1990s, 7-year and 10-year National Debt Management Fund Bonds were issued to lengthen the maturity of government debt. More than 90% of corporate bonds, which still dominated the market at that time, had a 3-year maturity.

On the infrastructure side, the Bank of Korea (BOK) launched BOK Wire in December 1994, a real-time gross settlement system for high-value payments typical in the bond market. BOK Wire introduced a guarantee of settlement finality and effectively eliminated settlement risk. Also, with the establishment of the Korea Securities Depository (KSD) in 1994, the use of KSD became mandatory for bond settlement. The efforts to modernize the payment and settlement systems laid the foundation for the emergence and growth of the repurchase (repo) and securities lending markets within the next few years.

The Government of the Republic of Korea had initially allowed nonresidents to invest directly in the bond market, starting with bonds issued by small and medium-sized enterprises (SMEs) in 1994, and planned to gradually expand the scope of eligible bonds. However, such plans were accelerated with the full opening of the Korean bond market to foreign investment following the 1997/98 Asian financial crisis as almost all restrictions on foreign investment in bonds were lifted under measures designated by the International Monetary Fund.

B. After the 1997/1998 Asian Financial Crisis

In the aftermath of the 1997/98 Asian financial crisis, the bond market underwent dramatic changes and emerged structurally different in the post-crisis period. First, the market shifted its focus from corporate bonds to government bonds, centered on KTBs. Second, corporate bonds accounted for a decreasing portion of the bond market, while non-guaranteed bonds replaced the previously dominant guaranteed bonds in the corporate bond market. Third, the bond market became more diverse with the advent of asset-backed securities (ABS) and structured securities whose underlying assets consisted of bonds. A rise in the share of foreign investment in the bond market also resulted from increased market diversity.

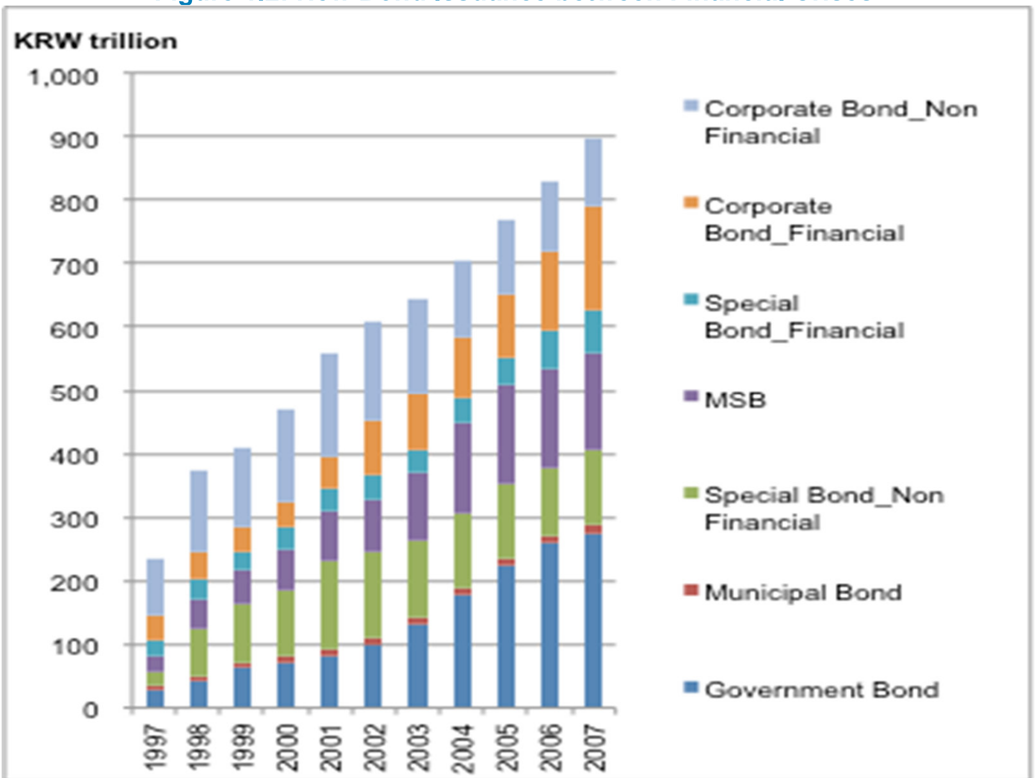
Such changes were attributed to the implementation of diverse policies and the efforts of market participants to address the causes of the 1997/98 Asian financial crisis. The Republic of Korea's financial crisis seemingly stemmed from the sudden depletion of the country’s foreign reserves, but institutional flaws in financial markets amplified the crisis.

A variety of policies were put in place to improve and deepen the shallow and narrow bond market, which was the result of market’s small size and limited number of participants, a lack of market transparency, and the inconsistent application of international standards.

Most noteworthy were the introduction of the Primary Dealer system and the launch of the KRX KTB, an inter-dealer market for KTBs established on KRX in 1999. The Primary Dealer system, in particular, enabled government bonds to be sold through competitive bids, unlike the previous practice in which major government bonds had been issued and sold through planned allocations to financial institutions. As guarantee providers refrained from issuing guarantees for corporate bonds in the wake of the 1997/98 Asian financial crisis, the corporate bond market dwindled; guaranteed corporate bonds as a proportion of total new bond issuances plunged below 5% in the 2000s. From the mid-2000s onward, guaranteed bonds almost disappeared from the corporate bond market. By contrast, government bond issuance was on the rise, owing to the government’s policy to nurture the KTB market. Figures 1.2 and 1.3 track new bond issuances and outstanding amounts, respectively, between the 1997/98 Asian financial crisis and the global financial crisis.

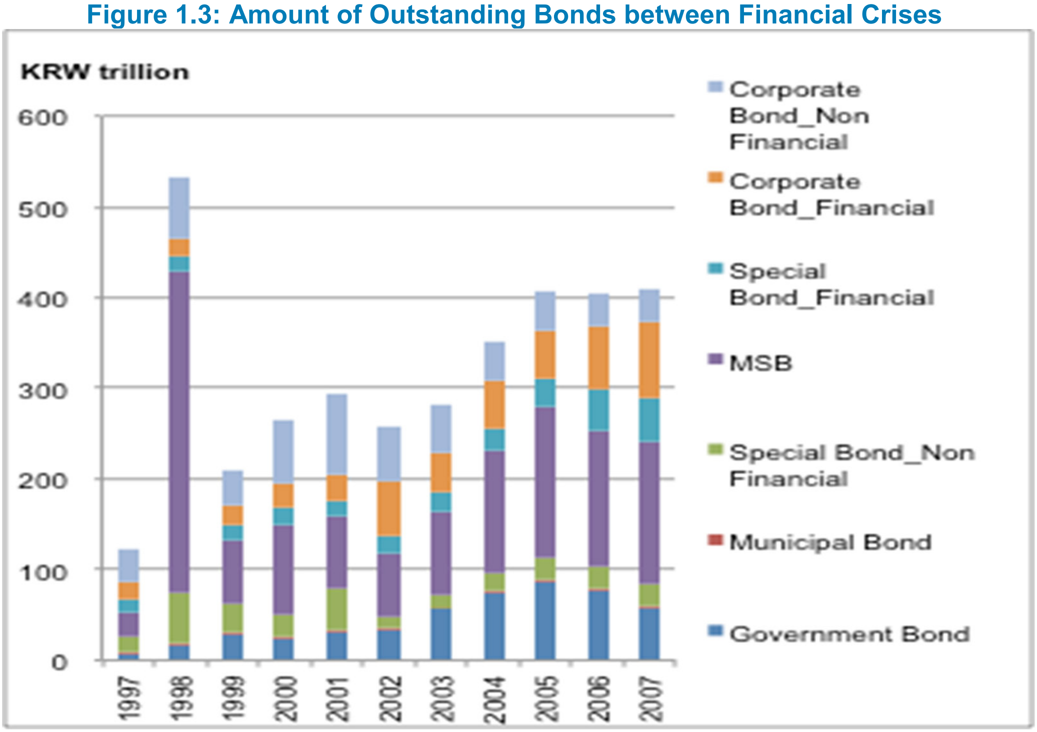
Because information about transactions on the exchange is disclosed in real time to market participants, the growth in government bond transactions in the KRX KTB brought about improvements in the transparency of the secondary bond market. Grain Bonds and National Debt Management Fund Bonds were integrated into KTBs in 2000 and 2003, respectively, in order to expand the liquidity base for government bonds. And the fungible issue system, in which new KTBs issued within a specified period are regarded as the same KTB issue, was introduced in 2000.

Figure 1.2: New Bond Issuance between Financial Crises



MSB = Monetary Stabilization Bond.
Source: Koscom.

Figure 1.3: Amount of Outstanding Bonds between Financial Crises



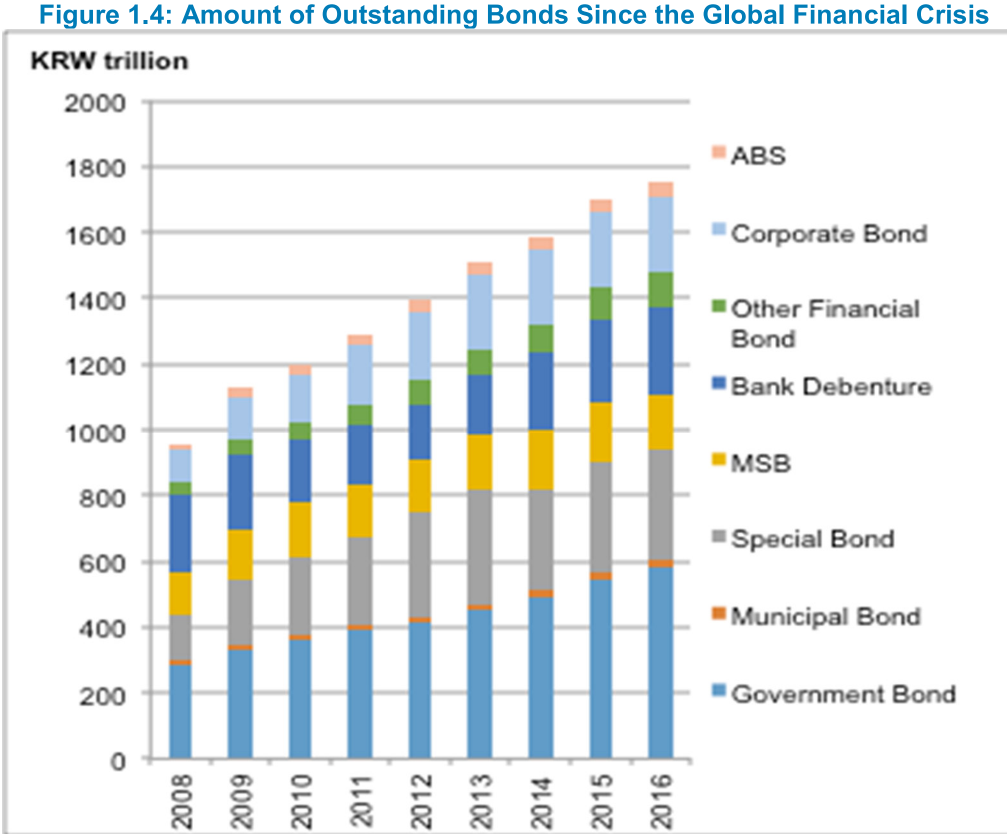
MSB = Monetary Stabilization Bond.
Source: Koscom.

The fungibility of KTBs was initially set to a 3-month basis, but the fungible issue period was extended to 6 months as KTB maturities were lengthened. The Republic of Korea started to issue 10-year KTBs in 2000, 20-year KTBs in 2006, 30-year KTBs in 2012, and 50-year KTBs in 2016.

Over time, a number of measures were introduced to make the OTC market more transparent. For example, the "15-minute rule" was introduced in 2000 and the Bond Quotation System (BQS) in 2007. Under the pre- and post-trade transparency regime for the OTC market, the online bond trading system FreeBond was launched in 2010 to organize the OTC market and facilitate OTC transactions. FreeBond was recently upgraded to K-Bond (see also Chapter IV).

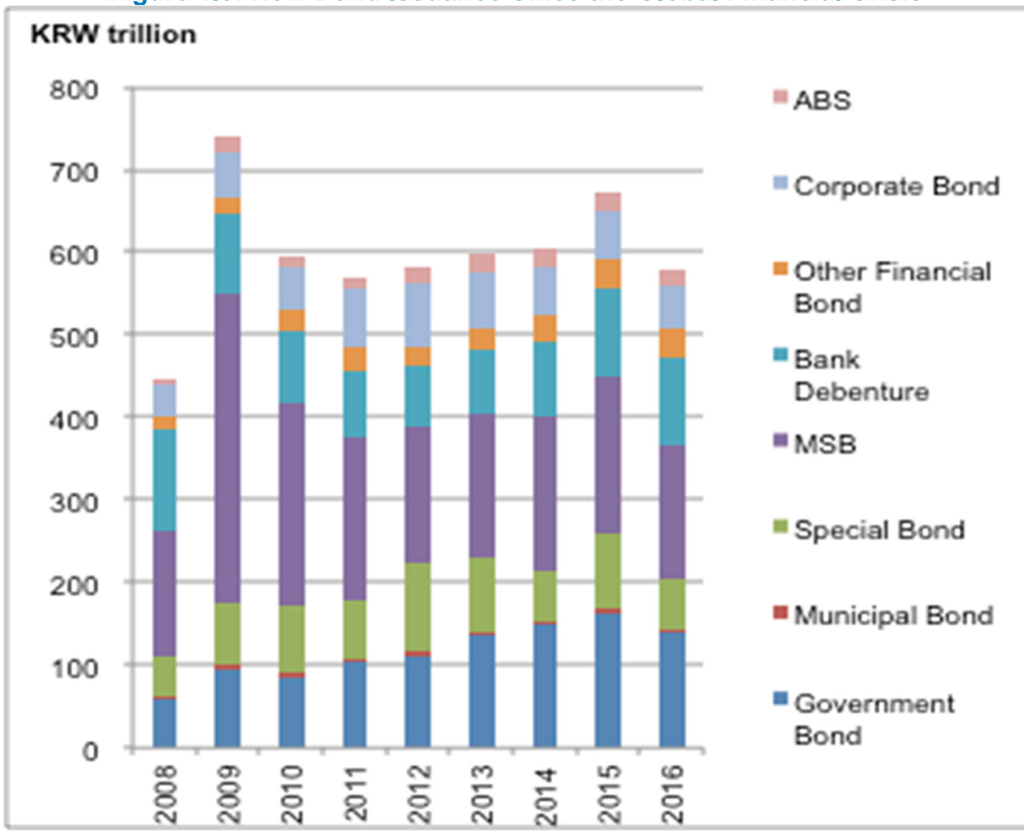
Based on its experience in overcoming the 1997/98 Asian financial crisis, the Republic of Korea continued along a stable growth path with relatively less exposure to the effects of the global financial crisis that began in late 2007. Despite the global financial crisis, the volume of outstanding bonds, which had stood at about KRW890 trillion at the end of 2007, surpassed KRW1,000 trillion in 2009 and increased to KRW1,750 trillion at the end of 2016 (Figure 1.4). In the case of MSBs, however, new issues in 2009 were large enough to account for 50% of aggregate new bond issues, but their portion in total outstanding bonds only amounted to around 13% in 2009 because the majority of MSBs at the time were short-term notes. Recently, the proportion of MSBs among outstanding amounts dropped to below 10% (Figure 1.5).

Figure 1.4: Amount of Outstanding Bonds Since the Global Financial Crisis



ABS = asset-backed securities, MSB = Monetary Stabilization Bond.
Source: Koscom.

Figure 1.5: New Bond Issuance Since the Global Financial Crisis



ABS = asset-backed securities, MSB = Monetary Stabilization Bond.
Source: Koscom.

The contraction in the corporate bond market, on the other hand, weakened the private sector's financing abilities through the capital market. In particular, bond issuance by SMEs with poor credit quality shrank further. To facilitate SME financing through the bond market, the Qualified Institutional Buyer (QIB) Market was launched in 2012. Privately placed bonds issued by firms with assets less than KRW500 billion can be traded in this market if such issuers meet certain requirements.

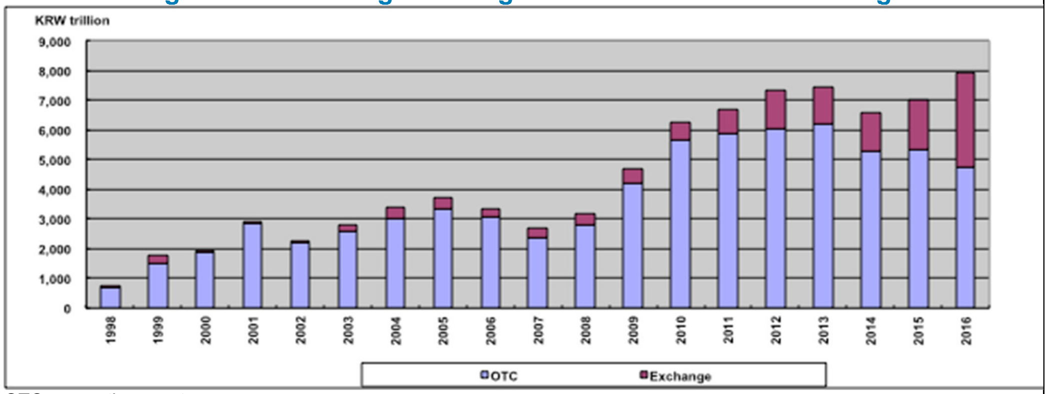
By the end of 2016, as a result of deregulation, the scope of eligible issuers was expanded to include all companies with assets less than KRW2 trillion. Regardless of their asset size, foreign companies were allowed to issue bonds in the QIB Market, which paved the way for nonresidents to secure an easy route to issue bonds.

In addition, a due diligence and book-building system for publicly offered non-guaranteed corporate bonds was introduced to improve transparency in the primary market. Similar to an auction system, it was aimed at capturing effective demand from institutional investors and determining a reasonable offer rate for a target bond issue. Since its introduction in April 2012, the system has undergone additional institutional improvements, becoming a fundamental part of the corporate bond issuance process.

The increased bond issuance volume and the improved institutional framework in the primary market have led to a rise in the volume of bond transactions in the secondary market. Particularly, the Financial Investment Services and Capital Market Act (FSCMA), enacted in 2009 and further revised in 2011, contained the fundamentals for the institutional structure of the Korean capital market.

As shown in Figure 1.6, bond transactions have increased significantly from only about KRW700 trillion in 1998 to about KRW8,000 trillion in 2016. Except for declines, notably in OTC trades, during the global financial crisis in 2007–2008 and again in 2014, the growth has been steady. In a separate development from the increased trading volume, the proportion of bonds traded on the exchange, most of which were KTB trades, has climbed gradually to about 40% of total bond trades in 2016.

Figure 1.6: Exchange Trading vs. Over-the-Counter Trading



OTC = over-the-counter.
Note: OTC trading volume is calculated as the sum of the traded amount for the buy and sell side (so-called "double counting"). Meanwhile, the exchange trading volume is calculated as the actual traded amount (so-called "single counting").
Sources: Korea Exchange, Korea Financial Investment Association.

An increase in the trading of bonds as an underlying asset made possible the growth of the market for derivatives linked to bonds. Following the introduction of 3-year KTB futures in 1999, 5-year and 10-year KTB futures were introduced in 2003 and 2008, respectively, and have been traded actively. Structured products such as KTB exchange-traded funds (ETFs) have also been introduced, which helped increase overall bond market diversity.

In line with the bond market's development, the repo market expanded and bond borrowing and lending transactions increased, adding liquidity to the bond market and strengthening the diversity of bond portfolio management. The repo market was launched in the mid-1970s to cater mainly to retail investors. In late 1999, KSD began to provide a triparty repo service. In 2002, KRX launched the repo market for institutional investors on its trading platform. These developments became drivers for structural change in the bond market.

Active utilization of the securities borrowing and lending facility provided by KSD from 1996 onward also contributed to increased liquidity in the bond market. The Korea Securities Finance Corporation (KSFC) started to provide bond borrowing and lending services in 2000, expanding its repo-linked borrowing and lending. KSFC has also participated as an intermediary in the OTC institutional repo market since 2011.

The quantitative growth and qualitative changes in the bond market heightened the need for investor protection. Subsequently, an indenture trustee system was adopted in 2012 to replace the existing bond trustee system, which was believed to be favoring issuers who were paying the service fees to bond trustees.

C. Challenges and Future Direction

In spite of its multifaceted development, the Korean bond market faces various challenges. Most notable is the recent stagnation of private sector financing through the capital market, which may be a result of the corporate bond market's contraction owing to crowding-out effects from the government bond market. Another challenge is the polarization of issuance by issuers with different credit ratings.

1. Stagnation in Private Sector Financing Through the Capital Market

The proportion of nonfinancial corporate bonds among total listed bonds reached a record high of 65% in the mid-1980s and hovered around 40% before the 1997/98 Asian financial crisis. However, the proportion of nonfinancial corporate bonds started to decline sharply in the wake of the 1997/98 Asian financial crisis. In recent times, corporate bonds have accounted for only around 10% of total bonds outstanding.

Traditionally, corporate bond issuance via public offering has been an important source of corporate financing. However, issuance volume and bonds' proportion of total corporate financing have shown little improvement while exhibiting high volatility. As Table 1.1 indicates, the proportion of corporate bonds to the total amount of corporate financing was 87.7% in 2005; this share dipped sharply in 2007 with the onset of the global financial crisis, but bond issuance recovered and bonds' share of corporate financing was largely stable in 2008–2011 before rising as high as 98.2% in 2012. In 2016, however, bonds accounted for 91.5% of corporate financing, illustrating the subsequent decline and stagnation of corporate bond issuance volumes.

Table 1.1: Corporate Financing Through Public Offering of Corporate Bonds
(KRW billion, %)

Year	Corporate Bonds		Total Amount (Stocks + Bonds)
	Issued Amount	Share of Total	
2005	48,103	87.7%	54,866
2006	41,678	86.5%	48,178
2007	45,160	72.4%	62,417
2008	74,116	93.6%	79,196
2009	114,940	91.8%	126,556
2010	112,919	93.8%	123,259
2011	130,492	91.0%	143,385
2012	128,693	98.2%	131,056
2013	116,295	95.7%	121,497
2014	116,172	95.3%	121,838
2015	123,102	93.9%	131,114
2016	109,858	91.5%	120,116

Source: Financial Supervisory Service.

2. Polarization of Issuance by Issuers with Different Credit Ratings

Issuance polarization among nonfinancial corporate bonds has become more severe because credit ratings are overly concentrated in a particular, higher-rated category. As of 2016, about 96% of nonfinancial corporate bonds were rated A or above. As a result, it has become difficult even for BBB-rated (investment grade) companies to issue bonds.

The stagnation in corporate bonds as a proportion of the bond market in the aftermath of the two financial crises was due in part to the improved capital structures of Korean firms. Given little change in the bond proportion of total debt held by domestic companies before and after the financial crises, the decreased proportion of corporate bond issuance resulted from corporates' debt reduction. The debt-to-equity ratio of large firms, which at one point had exceeded more than 1,000% (10 times) in the mid-1990s, plunged in the wake of the 1997/98 Asian financial crisis. It fell further to less than 100% in the wake of the global financial crisis in 2007–2008.

However, bonds issued by SMEs, which had reached nearly 28% of the volume of issuance by large firms in the early 1990s, dropped drastically in the aftermath of the two crises and stood at only about 1% after the global financial crisis. This well illustrates the polarization of the Korean bond market.

Hence, the financial authorities needed to take policy measures to facilitate the issuance of bonds by SMEs that carry a higher credit risk and are subject to asymmetric information problems. One of the policy measures was the launch of the QIB Market in 2012 (see section B), which is the bond market for professional investors.

3. Imbalance between Bond Investment and Issuance by Nonresidents

One of the challenges facing the Korean bond market is the deepening imbalance between bond investment and issuance by nonresidents. Underpinned by the growth of the bond market, foreign investment in domestic bonds has steadily increased since the mid-2000s. While foreign investors held merely KRW1 trillion worth of Korean bonds in the early 2000s, their investments exceeded KRW100 trillion in 2015. Bond investment by foreign investors tends to be concentrated in specific types of bonds, mainly KTBs and MSBs.

On the other hand, the volume of bonds issued by nonresidents in the Republic of Korea is still insignificant. As of 2016, the volume of outstanding bonds issued by nonresidents through public and private placements stood at KRW320 billion and KRW440 billion, respectively, together representing only 0.04% of total outstanding bonds in the Korean bond market.

4. Professional Market as a Driver of Bond Market Development

A market for professional investors can be characterized by lowered entry barriers for securities issuers through a loosening of the full disclosure requirements (i.e., the introduction of concise disclosure), the participation of qualified investors who possess sophisticated information gathering capabilities and large amounts of capital to invest, and free trading only among qualified investors without resale restrictions.

The capital market in the Republic of Korea has developed as market infrastructure has been established for professional investors. On the other hand, the markets for professional investors have gradually opened their doors to foreign issuers. The deregulation of the QIB Market, which came into force in 2016, widened the range of SME issuers and expanded the issuer scope beyond SMEs, allowing foreign issuers to raise capital in the domestic QIB Market.

5. Importance of Joining the ASEAN+3 Multi-Currency Bond Issuance Framework

The ASEAN+3 Multi-Currency Bond Issuance Framework (AMBIF), which represents bond and note issuance to professional investors only, can provide opportunities for Koreans to invest in bonds issued by foreign issuers and give Korean firms easier access to capital in the region. Moreover, Korean investors can contribute to regional financial integration by participating in other ASEAN+3 bond markets. In turn, it would help strengthen regional cooperation and play a part in regional co-development.