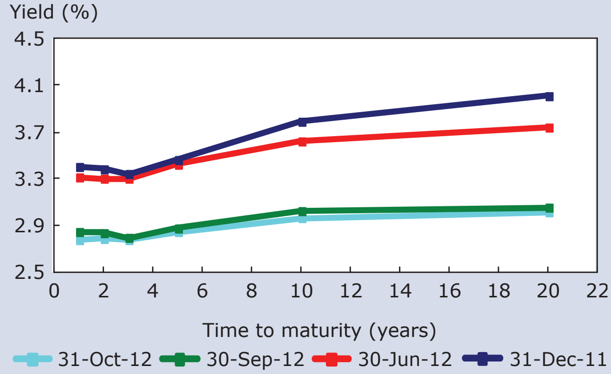
Republic of Korea—Update

Yield Movements

Government bond yields in the Republic of Korea fell for all tenors between end-June and end-September **(Figure 1)**. The drop in yields in 3Q12 ranged from 47 basis points (bps) for the 1- and 2-year tenors to 69 bps for the 20-year tenor. Yields fell further for all tenors between end-September and end-October. The decline in yields since end-June has been attributed to expectations of policy rate cuts amid a sluggish global economy. Meanwhile, the yield spread between the 2- and 10-year tenors narrowed 13 bps between end-June and end-September, and decreased slightly by 1 bp between end-September and end-October.

Figure 1: The Republic of Korea's Benchmark Yield Curve—LCY Government Bonds



LCY = local currency.
Source: Bloomberg LP.

The Bank of Korea's Monetary Policy Committee decided on 9 November to keep the base rate—the 7-day repurchase rate—steady at 2.75%. In its previous meeting in October, the committee decided to reduce the policy rate by 25 bps from 3.00% to 2.75%, and to lower the interest rate on Aggregate Credit Ceiling Loans to 1.25% from 1.50%. Consumer price inflation inched up to 2.1% year-on-year (y-o-y) in October from 2.0% in September.

Real gross domestic product (GDP) growth of the Republic of Korea eased to 1.6% y-o-y in 3Q12 from 2.3% in 2Q12, based on advance estimates of The Bank of Korea. The Bank of Korea in October revised downward its 2012 GDP growth forecast for the Republic of Korea to 2.4% from an earlier estimate of 3.0% made in July. It also lowered its forecast for 2013 to 3.2% from 3.8%.

Size and Composition

Total local currency (LCY) bonds outstanding in the Republic of Korea expanded 9.6% y-o-y and 2.1% quarter-on-quarter (q-o-q) to reach KRW1,523 trillion (US$1.4 trillion) at end-September **(Table 1)**. The outstanding amount of LCY government bonds amounted to KRW603.6 trillion, up 2.2% y-o-y and 0.4% q-o-q. The central government's bonds outstanding rose 5.8% y-o-y and 1.3% q-o-q to reach KRW413.8 trillion. Meanwhile, central bank bonds were valued at KRW162.5 trillion, down 4.1% y-o-y and 1.3% q-o-q, while industrial finance debentures also slipped 8.4% y-o-y and 3.3% q-o-q to level off at KRW27.3 trillion.

Issuance of LCY government bonds in 3Q12 totaled KRW63.3 trillion, which was down 5.1% from the previous quarter. The quarterly drop was induced by an 8.2% fall in central bank bond issuance, which stood at KRW39.0 trillion in 3Q12, compared with KRW42.5 trillion in the previous quarter. Meanwhile, issuance of central government bonds inched up 0.4% q-o-q to KRW22.7 trillion, while issuance of industrial finance debentures slipped 2.0% q-o-q to KRW1.6 trillion in 2Q12.

Total LCY corporate bonds outstanding grew 15.1% y-o-y and 3.3% q-o-q to reach KRW919.3 trillion at end-September. This growth was bolstered by increases of 23.5% y-o-y and 5.2% q-o-q for private corporate bonds outstanding, which rose to a level of

Table 1: Size and Composition of the LCY Bond Market in the Republic of Korea

	Amount (billion)								Growth Rate (%)						
	Jun-12		Jul-12		Aug-12		Sep-12		Jun-12		Jul-12	Aug-12	Sep-12		
	KRW	US$	KRW	US$	KRW	US$	KRW	US$	y-o-y	q-o-q	m-o-m	m-o-m	y-o-y	q-o-q	m-o-m
Total	1,491,463	1,302	1,501,447	1,328	1,514,137	1,334	1,522,869	1,370	9.7	2.1	0.7	0.8	9.6	2.1	0.6
Government	601,162	525	605,189	535	604,655	533	603,590	543	3.0	(0.05)	0.7	(0.1)	2.2	0.4	(0.2)
Central Bank Bonds	164,580	144	166,240	147	162,000	143	162,460	146	(1.5)	(2.0)	1.0	(2.6)	(4.1)	(1.3)	0.3
Central Government Bonds	408,361	357	411,271	364	415,533	366	413,848	372	5.5	1.1	0.7	1.0	5.8	1.3	(0.4)
Industrial Finance Debentures	28,221	25	27,678	24	27,122	24	27,283	25	(4.4)	(5.0)	(1.9)	(2.0)	(8.4)	(3.3)	0.6
Corporate	890,301	777	896,258	793	909,482	802	919,279	827	14.7	3.6	0.7	1.5	15.1	3.3	1.1

LCY = local currency, m-o-m = month-on-month, q-o-q = quarter-on-quarter, y-o-y = year-on-year.
Notes:
1. Calculated using data from national sources.
2. Bloomberg LP end-of-period LCY–US$ rates are used.
3. Growth rates are calculated from LCY base and do not include currency effects.
Source: EDAILY *BondWeb* and The Bank of Korea.

KRW409.9 trillion. Also, the outstanding size of special public bonds climbed 16.7% y-o-y and 3.1% q-o-q to KRW305.3 trillion. In contrast, the outstanding size of financial debentures, excluding Korea Development Bank (KDB) Bonds, marginally fell 0.5% y-o-y and 0.2% q-o-q to level off at KRW204.1 trillion at end-September.

The top 30 LCY corporate bond issuers at end-September had combined outstanding bonds of KRW568.0 trillion, accounting for 62% of total LCY corporate bonds outstanding **(Table 2)**. Korea Land & Housing Corp. remained the largest issuer of corporate bonds with a total outstanding amount of KRW57.0 trillion.

Issuance of LCY corporate bonds in 3Q12 amounted to KRW96.8 trillion, which was 1.5% lower than in the previous quarter. The quarterly decline stemmed from a 9.7% q-o-q fall in issuance of private corporate bonds, outweighing the 12.7% and 4.2% q-o-q increases in issuance of special public bonds and financial debentures, respectively.

The largest LCY corporate bond issues in 3Q12 included Kookmin Bank's KRW500 billion 10-year bond offering a 3.4% coupon, Hyundai Heavy Industries' KRW400 billion 5-year bond carrying a 3.35% coupon, and Lotte Shopping's 3-year bond with a 2.98% coupon. The longest-dated LCY corporate bond issued during the quarter was Korea Expressway's 50-year bond worth KRW100 billion carrying a 3.48% coupon. Meanwhile, among the high-yield corporate bond issues made in 3Q12 were a 3-year asset-backed security (ABS) worth KRW6.8 billion issued by Gibo Green Hitech 1st Securitization Specialty Inc. at a coupon rate of 10.0%, Dongbu Corporation's 1-year bond worth KRW70 billion carrying an 8.9% coupon, and Tongyang Inc.'s 1.5-year bond worth KRW130 billion offering a 7.4% coupon.

Liquidity

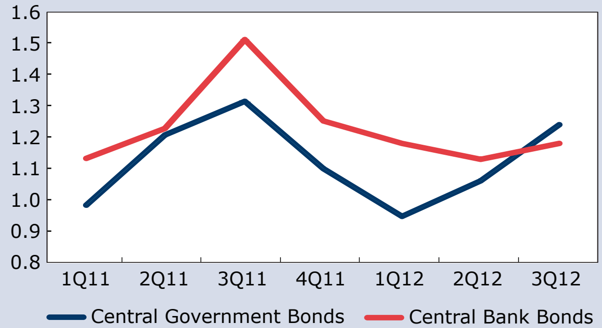
Liquidity in LCY government bonds improved in 3Q12, as the turnover ratio for government bonds increased to 1.16, compared with 1.02 in 2Q12

Table 2: Top 30 Issuers of LCY Corporate Bonds in the Republic of Korea (as of end-September 2012)

Issuers	Outstanding Amount		State-Owned	Privately-Owned	Listed on		Type of Industry
	LCY Bonds (KRW billion)	LCY Bonds (US$ billion)			KOSPI	KOSDAQ	
1. Korea Land & Housing Corp.	56,983	51.3	Yes	No	No	No	Real Estate
2. Korea Housing Finance Corp.	41,209	37.1	Yes	No	No	No	Financial
3. Korea Deposit Insurance Corp.	39,740	35.8	Yes	No	No	No	Insurance
4. Korea Finance Corp.	37,130	33.4	Yes	No	No	No	Financial
5. Korea Electric Power Corp.	29,550	26.6	Yes	No	Yes	No	Utillity
6. KDB Daewoo Securities	29,436	26.5	Yes	No	Yes	No	Securities
7. Industrial Bank of Korea	27,866	25.1	Yes	No	Yes	No	Bank
8. Woori Investment and Securities	23,599	21.2	Yes	No	Yes	No	Securities
9. Korea Investment and Securities	21,635	19.5	No	Yes	No	No	Securities
10. Korea Expressway Corp.	19,740	17.8	Yes	No	No	No	Infrastructure
11. Shinhan Bank	19,098	17.2	No	Yes	No	No	Bank
12. Kookmin Bank	18,828	16.9	No	Yes	No	No	Bank
13. Mirae Asset Securities	18,142	16.3	No	Yes	Yes	No	Securities
14. Tong Yang Securities	16,797	15.1	No	Yes	Yes	No	Securities
15. Woori Bank	15,992	14.4	Yes	No	No	No	Bank
16. Small & Medium Business Corp.	15,168	13.6	Yes	No	No	No	Financial
17. Korea Rail Network Authority	13,760	12.4	Yes	No	No	No	Infrastructure
18. Korea Gas Corp.	12,845	11.6	Yes	No	Yes	No	Utility
19. Hana Bank	12,464	11.2	No	Yes	No	No	Bank
20. Hyundai Securities	11,146	10.0	No	Yes	Yes	No	Securities
21. Hana Daetoo Securities	10,964	9.9	No	Yes	No	No	Securities
22. Korea Water Resources	9,387	8.4	Yes	No	Yes	No	Utility
23. Standard Chartered First Bank Korea	9,040	8.1	No	Yes	No	No	Bank
24. Shinhan Investment Corp.	8,990	8.1	No	Yes	No	No	Securities
25. Shinhan Card	8,648	7.8	No	Yes	No	No	Financial
26. Korea Eximbank	8,370	7.5	Yes	No	No	No	Bank
27. Hyundai Capital Services	8,235	7.4	No	Yes	No	No	Securities
28. Korea Railroad Corp.	7,860	7.1	Yes	No	No	No	Infrastructure
29. Shinhan Financial Group	7,690	6.9	No	Yes	Yes	No	Financial
30. Samsung Securities	7,675	6.9	No	Yes	Yes	No	Securities
Total Top 30 LCY Corporate Issuers	**567,989**	**511.1**					
Total LCY Corporate Bonds	**919,279**	**827.2**					
Top 30 as % of Total LCY Corporate Bonds	**61.8%**	**61.8%**					

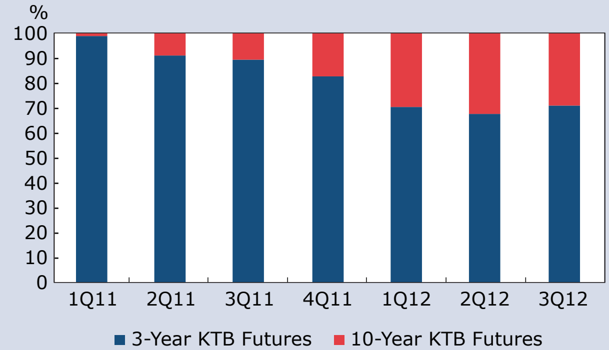
KOSPI = Korea Composite Stock Price Index, KOSDAQ = Korean Securities Dealers Automated Quotations, LCY = local currency.
Source: *AsianBondsOnline*, Bloomberg LP, and EDAILY *BondWeb*.

Figure 2: Turnover Ratio for Central Government and Central Bank Bonds, 1Q11-3Q12



Note: Central government bonds include treasury bonds and National Housing Bonds.
Source: The Bank of Korea and EDAILY *BondWeb*.

Figure 3: Trading Volume of KTB Futures Contracts, 1Q11–3Q12 (%)



KTB = Korea Treasury Bond.
Source: Korea Exchange.

and 0.96 in 1Q12. Between 2Q12 and 3Q12, the turnover ratio for central government bonds, mostly Korea Treasury Bonds (KTBs), rose from 1.06 to 1.24, while also climbing for Monetary Stabilization Bonds (MSBs) from 1.13 to 1.18 **(Figure 2)**.

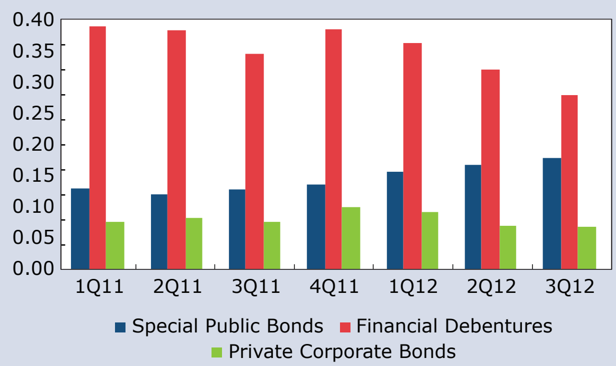
Trading activity in the KTB futures market strengthened in 3Q12, as the number of KTB futures contracts traded rose to 9.5 million for the quarter from 6.3 million in 2Q12. About 71% of the total KTB futures contracts traded in 3Q12 were 3-year, while the rest were 10-year **(Figure 3)**.

For LCY corporate bonds, the turnover ratio fell marginally to 0.15 in 3Q12 from 0.16 in 2Q12, induced by lower trading activity for financial debentures. Between 2Q12 and 3Q12, the turnover ratio for financial debentures fell to 0.28 from 0.32, inched up for special public bonds from 0.17 to 0.18, and remained unchanged for private corporate bonds at 0.07 **(Figure 4)**.

Investor Profile

Insurance companies and pension funds remained the largest investor group in LCY government bonds in 2Q12, holding 24% of total government bonds at end-June **(Figure 5)**. They were followed by the general government—consisting of the central government, local government, and social security funds—which held 23% of

Figure 4: Turnover Ratios for Special Public Bonds, Financial Debentures, and Private Corporate Bonds, 1Q11–3Q12

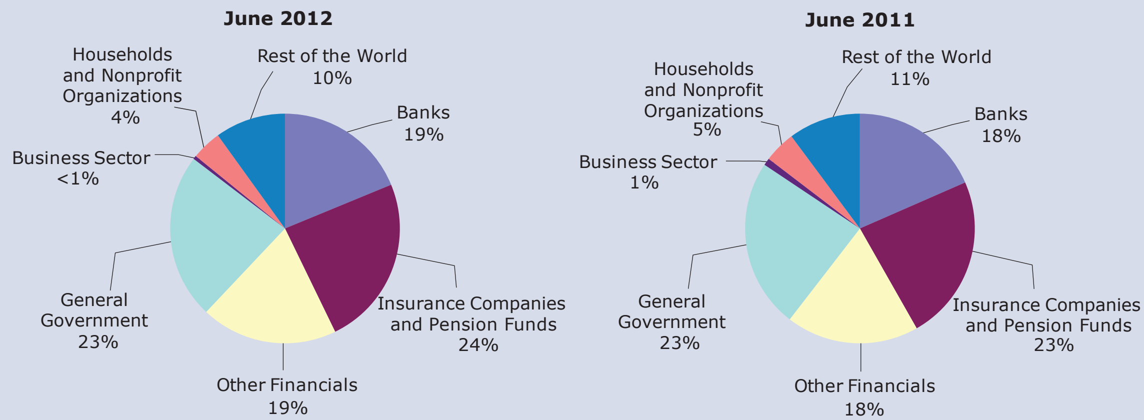


Source: EDAILY *BondWeb*.

the total. Banks and other financial companies each held 19%, while foreign investors owned 10%. Compared with end-June 2011, the shares of insurance companies and pension funds, banks, and other financial companies rose by 1 percentage point each. In contrast, the shares of households and nonprofit organizations, non-financial corporates, and foreign investors fell by 1 percentage point each.

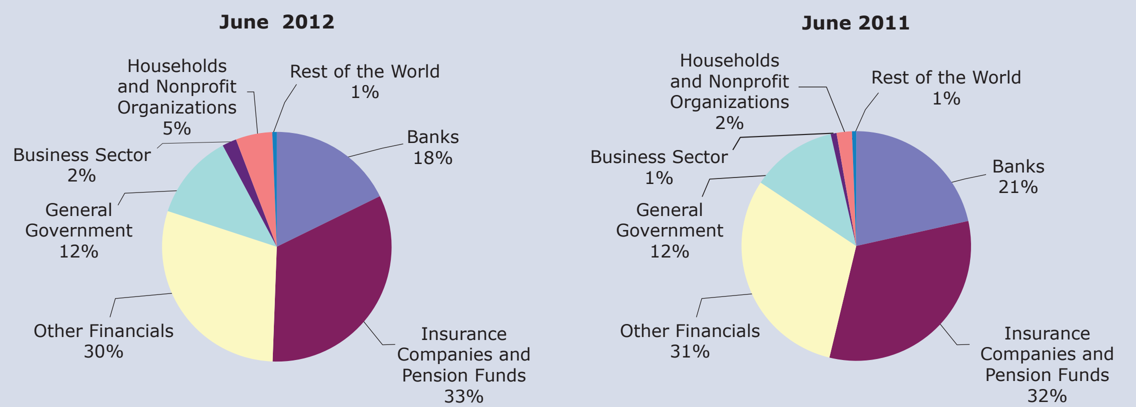
Insurance companies and pension funds were also the largest investor group in LCY corporate bonds, holding 33% of the total as of end-June **(Figure 6)**. Financial companies other than banks were the second-largest corporate bondholders with a share of 30%, followed by banks (18%), the

Figure 5: LCY Government Bonds Investor Profile



LCY = local currency.
Source: *AsianBondsOnline* and The Bank of Korea.

Figure 6: LCY Corporate Bonds Investor Profile



LCY = local currency.
Source: *AsianBondsOnline* and The Bank of Korea.

general government (12%), households and nonprofit organizations (5%), non-financial companies (2%), and foreign investors (1%). Between end-June 2011 and end-June 2012, the share of households and nonprofit organizations rose 3 percentage points, while insurance companies and pension funds, and non-financial corporates, both recorded a 1 percentage point increase in their respective shares. In contrast, the shares of banks and other financial companies fell 3 percentage points and 1 percentage point, respectively.

Rating Changes

Standard and Poor's (S&P) announced in September that it had upgraded the Republic of Korea's foreign currency (FCY) long-term rating to A+ from A, the LCY long-term rating to AA– from A+, and the LCY short-term rating to A-1+ from A-1 **(Table 3)**. Also in September, Fitch Ratings upgraded the country's long-term FCY issuer default rating to AA– from A+, and the short-term FCY issuer default rating to F1+ from F1, with a stable outlook for both. According to Fitch, the ratings upgrade reflects the

Table 3: Selected Sovereign Ratings and Outlook for the Republic of Korea

	Moody's	S&P	Fitch	R&I
Sovereign FCY LT Ratings	Aa3	A+	AA–	A+
Outlook	Stable	Stable	Stable	Stable

FCY = foreign currency, LT = long term.
Source: Rating agencies.

country's strong macroeconomic policy framework, sustained fiscal discipline, and continued economic and financial stability. Meanwhile, Moody's Investor Service (Moody's) upgraded the FCY and LCY long-term ratings of the Republic of Korea to Aa3 from A1 in August.

Policy, Institutional, and Regulatory Developments

FSS Introduces Tighter Rules on Commercial Paper

The Financial Supervisory Service (FSS) announced in October that it had begun requiring issuers of asset-backed commercial paper to disclose the structure, credit ratings, and collateral of these instruments, together with information on the issuers' financial soundness and credit ratings. The FSS also announced that a one-stop inquiry system for commercial paper would be established in October and that it would strengthen its supervision of brokerages selling asset-backed commercial paper.

FSC Announces Measures to Strengthen Investor Protection in ELS/DLS Market

The Financial Services Commission (FSC) reported in September that a monitoring system for the issuance and operations of equity-linked securities (ELS) and derivatives-linked securities (DLS) would be established. To enhance investor protection, the FSC would discourage securities houses from issuing excessive short-term ELS and DLS.

FSC and FSS Revise Regulations on Bank Supervision

The FSC announced in September a joint effort with the FSS to revise regulations on bank supervision for domestic implementation of Basel III standards, which will take effect in 2013. The revisions will include subdividing the criteria for the minimum capital requirement, which is 8% of total capital, into three criterion: (i) 4.5% of common equity Tier 1 capital, (ii) 6% of Tier 1 capital, and (iii) 8% of total capital. The revisions will also include the introduction of a capital buffer of 2.5 percentage points in addition to the minimum capital requirement.