IX

Korean Bond Market Challenges and Opportunities

This chapter discusses some of the real and perceived challenges facing the Korean bond market and its participants, and also describes the possible mitigating factors or market developments that could address these challenges in an appropriate manner.

A. Challenges in the Korean Bond Market

1. Obligations and Procedures Applicable to Nonresidents

A number of obligations and procedures required for nonresidents would benefit from being improved to the extent possible.

a. Registration Requirement for Foreign Investors

Nonresident investors wishing to invest in the Korean bond market are required to register with the FSS and obtain an IRC (see also Chapter II.M.1); this practice has been in place for many years and had previously been considered a challenge, due to the initially cumbersome documentation requirements.

Today, obtaining an IRC has become an integral part of the service provision by the appointed custodian of the nonresident investor, and the process has been improved to be as smooth as possible. However, the need to obtain an IRC and to match the IRC against the legal ownership of assets continues to pose challenges for investment managers and other entities (see also Chapter VI.H.9).

Regulators have since introduced that foreign nationals, foreign-incorporated entities, and local branches of a foreign corporation engaging in business activities in the Republic of Korea that qualify for “foreigner under national treatment” status shall be exempt from this registration upon submitting documents verifying their status. Such exemption from registration will also apply to cases where government bonds and market stabilization bonds are acquired and sold using “omnibus accounts” under the name of the ICSD through an ICSD account.

At the same time, regulatory developments in other ASEAN+3 and international markets increasingly favor practices that allow the identification of legal or beneficial owners by means of investor IDs or account structure. In this context, the Korean practice continues to be relevant.

b. Restrictions on Over-the-Counter Transactions by Nonresidents

As a general rule, nonresidents must buy and sell listed securities only through the securities exchange unless authorized or allowed otherwise by the FSC under Article 188 (2) in Enforcement Decree of FSCMA.

Nonresident investors, naturally, can transact listed securities through KRX by placing orders to the securities companies that are members of KRX.

Direct access to the OTC market is not possible for nonresident investors. If a nonresident investor wants to trade listed bonds OTC, the trade must be conducted through the intermediation of Korean securities companies. Articles 6–7 of the Regulation on Financial Investment Business apply to almost all bonds issued in the Republic of Korea since most publicly issued and offered domestic bonds are listed on the exchange market.

If a transaction in the OTC market has to be made through a Korean securities firm, it is possible that foreign investors will have to pay additional costs or lose the possibility of finding an advantageous trading opportunity in comparison to having direct access to trading counterparties. Such possibilities may keep foreign financial companies from investing in Korean bonds or recommending Korean bonds to their customers.

2. Withholding Tax on Interest Income

In the Republic of Korea, tax on interest income is withheld as a rule, with different rates applied depending on the investor's residency. For residents, a 15.4% withholding tax is regularly levied on interest income from bonds (see Chapter VI.H for more details), unless a different tax rate is available for residents of countries that have signed a tax treaty with the Republic of Korea.

Nonetheless, the inconvenience arising from the submission of information for tax purposes, or the processing of tax returns, and the need to adjust tax based on the holding period add a level of complexity to bond trading and investment. For this reason, some countries, including developed countries, encourage bond investments from nonresident investors by abolishing or zero-rating withholding tax, or by exempting nonresidents from withholding tax on interest income.

Similarly, the Asian Bond Markets Initiative's Working Group 2 recommended abolishing or lowering withholding tax on interest income for foreign investors to attract increased foreign investment in domestic bonds.

3. Exemption from and Re-Imposition of Withholding Tax

In January 2009, in the middle of the currency crisis caused by the global financial crisis, the Government of the Republic of Korea decided to exempt nonresidents from withholding tax on interest income from all government bonds and MSBs. However, the government re-imposed a flexible tax on interest income and a 20% tax on capital gains from KTBs and MSBs held by foreign investors, effective 1 January 2011. This followed the passage of legislative bills in December 2010, which called for the restoration of the withholding tax in order to mitigate capital flow volatility and minimize systemic risks to the domestic economy.

In line with the general challenge of implementing withholding tax mentioned in section 2, the exemption and re-instatement of withholding tax for nonresidents caused confusion among foreign investors and led to a heightened caution toward investing in the Korean bond market.

4. Slow Development of Professional Bond Market

The development of a bond market segment for professional investors, or a professional bond market in the Republic of Korea, is lagging behind. One recent policy measures was the launch of the QIB Market in 2012, which was intended as the bond market segment for professional investors (see further details in section B.1). However, at the time, eligible issuers were limited to only SMEs, which greatly reduced the attractiveness of the issued debt securities to the targeted investor universe due to credit rating and other considerations.

In its Measures to Boost Competitiveness of Financial Investment Business, released in October 2015, the FSC announced the further deregulation of this market segment by shaping it as a more inclusive QIB Market with the use of international standards. The relevant regulations for the operation of the revised concept became effective on 1 August 2016.

The deregulation of the QIB Market broadened the issuer range from SMEs to medium-sized corporations, and allowed foreign issuers to raise capital in the domestic QIB Market, regardless of their size. Yet, in this improved QIB Market, there remains a restriction with regard to the participation of large domestic corporations. Large domestic corporations, with assets totaling KRW2 trillion or more, are unable to issue bonds and notes in the QIB Market, limiting the market's attraction to nonresident QIBs who may favor recognized issuer names.

Some of the intended objectives of the revised QIB Market have been put into practice. Pursuant to the new measures introduced by the FSC, KOFIA launched a QIB Market debt securities registration and disclosure platform on 1 August 2016. Issuers of debt securities—including foreign issuers—are required to register their instruments with KOFIA for them to be eligible for trading on the professional OTC market. The key feature of the new disclosure platform is that foreign issuers may utilize their standard issuance documentation and disclosure information in English; this was a first for an issuance in the Korean bond market.

Despite taking into consideration the above limitation, AMBIF issuances may be able to be accepted in this revised QIB Market. However, the issues under discussion in relation to AMBIF, such as taxation and foreign exchange, are not reflected in the QIB Market regulatory process and still need to be addressed separately.

B. Opportunities in the Korean Bond Market

1. Introduction of Professional Market Segments

The QIB Market, which launched in 2012, is the first professional market for bond investment. It also introduced the ability for bond market participants to be recognized as professional investors (QIBs) and to attract treatment suitable for professional investors (limited disclosure) and access to eligible instruments. The QIB Market is currently operated by KOFIA.

A market for professional investors should be characterized by (i) lowered entry barriers for a wide range of securities issuers through concise or relaxed disclosure requirements, (ii) the participation of qualified investors who possess sophisticated information gathering capability and large amounts of capital to invest, and (iii) free trading only among qualified investors and without resale restrictions. The QIB Market satisfies these characteristics and provides a great opportunity for issuers and professional investors alike.

This professional market concept has also been applied to the stock market. Case in point is the KONEX, launched by KRX in 2013, which is the SME stock market for professional investors.

KONEX is the stock market platform in KRX for professional investors, but its professional investor concept for the primary and secondary markets is very similar to that for the professional bond market. This means that the possible extension of this professional investor concept for a listed bond market for professional investors, with the participation of a wide range of domestic and foreign issuers, should easily attract the attention of eligible investors already familiar with the professional stock market segments.

Moreover, KRX opened the KSM Market in 2016, which imposes much more relaxed registration requirements on issuers. Using the KSM registration concept, KRX may introduce a new bond registration process that will satisfy AMBIF registration guidelines.

2. ASEAN+3 Multi-Currency Bond Issuance Framework

The introduction of AMBIF in regional markets over the course of 2015 signaled an opportunity for additional bond and note issuance activities in the domestic bond markets. Among the requirements for participation in AMBIF are the existence of a professional market segment to safeguard the investor protection framework for retail or general investors in each market, the need for bonds and notes to be registered or profile listed to ensure adequate continuous disclosure throughout the tenor of the bond, and the ability for issuers to use standardized issuance documentation in English across all participating markets.

With the latest developments of the QIB Market (i.e., a market for private placements to be traded in the OTC market under the governance of KOFIA), the Korean bond market now features a market segment that fulfills such key requirements for the implementation of AMBIF (see also section 1). With KONEX, KRX has also opened a professional market.

These markets define participants as professional investors. Companies listed on such markets, or issuers registering their debt securities in the case of the QIB Market, are subject to limited or defined initial and continuous disclosure obligations compared to main or retail markets.

In the process of opening the markets mentioned above, KRX has established a professional market scheme and accumulated know-how for building a professional market. Therefore, KRX expects that successful experience may easily be adopted to a professional bond market as well and would ensure that it will be a sustainable and well-organized market. The KONEX market infrastructure is ready to be utilized for a new professional market segment on KRX, equivalent to the QIB Market.

If AMBIF, as the issuance concept for bonds and notes for professional investors, were to be applied in the professional bond market segments in the Republic of Korea, it would provide opportunities for Koreans to invest in bonds issued by foreign issuers and also would give Korean firms easier access to capital in the region.

Moreover, the Republic of Korea can contribute to regional financial development by participating in ASEAN+3 bond markets. In turn, it would help strengthen regional cooperation and play a part in regional co-development. The implementation of AMBIF is expected to benefit the Korean bond market at large.