

Korean Treasury Bonds An International Perspective

July 2024

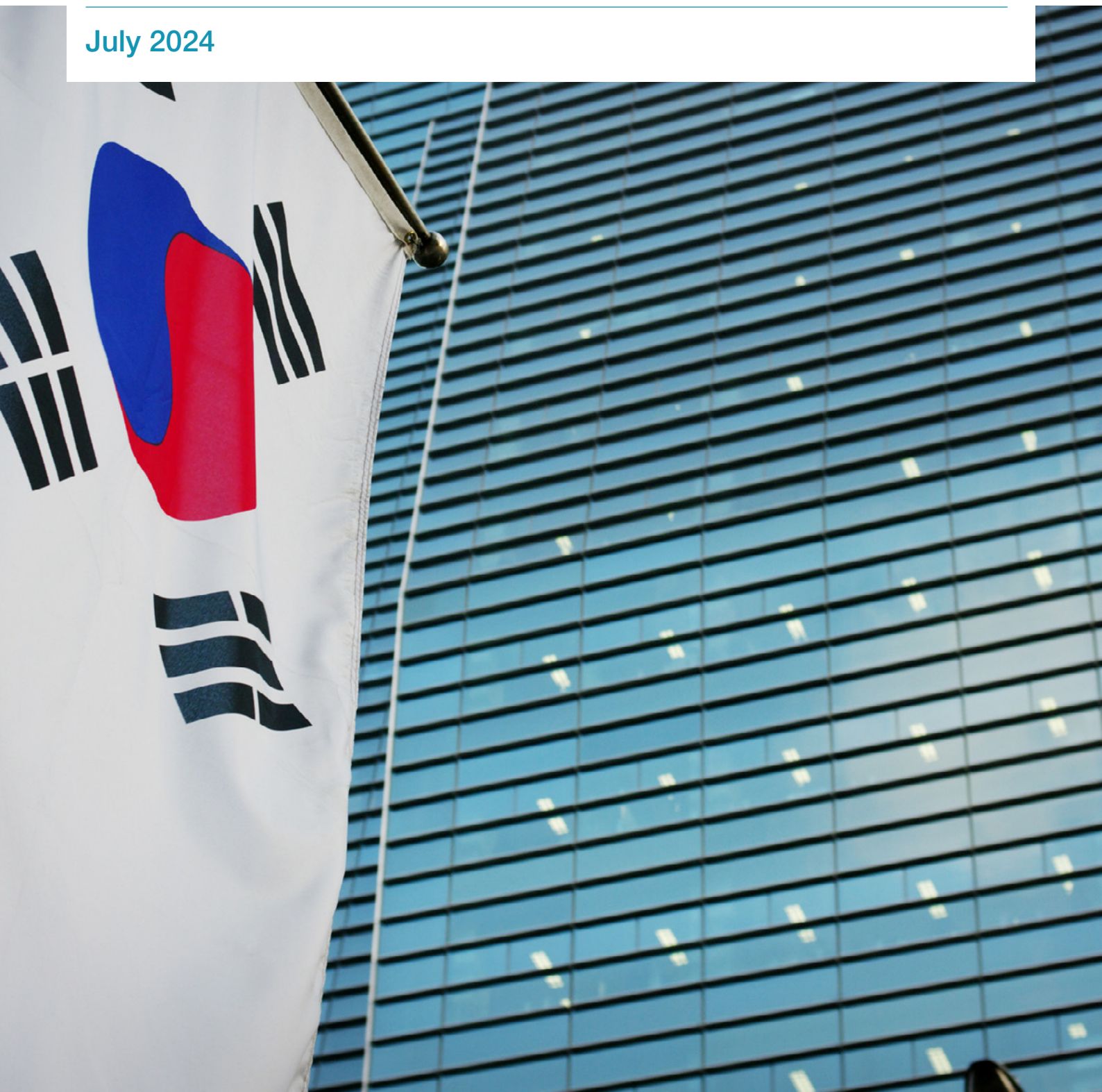


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Executive Summary

How do international market participants perceive the Korean Treasury Bond (KTB) markets? For offshore traders and investors, why trade KTBs? And what are the most essential reforms to market regulation and operations to make this possible? This report seeks to answer these questions and highlight ways in which the KTB markets may become more useful and accessible for international financial institutions.

This report is based on a market survey designed by ICMA and Bloomberg and sent widely to participants in the global fixed income markets. Of the more than 300 responses, more than 90% were from those who have never traded KTBs. The survey may therefore be especially useful to understand how the KTB markets could attract additional investors from abroad. The high response from those who have never traded KTBs also speaks to untapped opportunities for Korean bond issuers.

The recent news that KTBs are now clearable via international central securities depositories (ICSDs) is expected to be a welcomed development for many in the global investment community. In our survey conducted before this announcement, a majority of respondents (61%) said having KTBs cleared through Euroclear or Clearstream would drive an increase in trading volume. This had been a notable barrier holding many back from entering the KTB markets; 32% told us explicitly that making Korean government debt ICSD-clearable was necessary before they would explore the market further.

With that barrier eliminated, the focus can turn to simplifying the trading process for KTBs. Financial professionals told us they are looking for a streamlined third-party onshore foreign exchange process, an updated electronic trading platform enabling a bigger liquidity pool, and greater pricing transparency – among other improvements.

More market research is needed to assess the potential impact of changes to the IRC-LEI registration system. Some respondents appreciated the idea of eliminating the need to register for an IRC before trading KTBs, believing this could draw in new offshore investors. However, many others expressed concerns about increased compliance costs and regulatory requirements that could potentially discourage participation in this nascent asset class.

Otherwise, the survey revealed a wide variety of perceived challenges to KTB trading, in the realms of operational procedure, regulation, and market dynamics. The report concludes with an overview of these market perceptions from offshore.

Introduction

Why this Report?

Capital market reforms in South Korea have accelerated in recent years toward the goal of including Korean government bonds in international indices. While significant and concrete progress has been made so far, there has been to date a paucity of data on the overall views of international market participants on the market reforms.

In light of recent market developments, insights focused on KTB internationalisation are even more relevant and salient for the investment community at large. To help evaluate the current state of reform and inform future progress, ICMA and Bloomberg surveyed international market participants: whether, how, why and why not they may trade KTBs, as well as their wishes and expectations for future evolution of the markets. We also hope that regulators and policymakers can benefit from this research as they consider future reforms that will shape the KTB markets going forward.

Scope and Methodology

The main objective of this report is to assess the perceived impact of existing market reforms on KTB trading from an international market stakeholder's perspective, and to gauge market expectations on further reform initiatives in the Korean capital market.

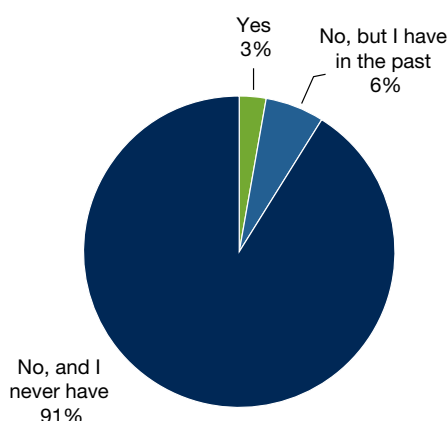
The survey was co-designed by Bloomberg and ICMA staff in the fixed income and Asia-Pacific teams. Including both multiple choice and open-ended questions, the survey was distributed by Bloomberg to client/member mailing lists of Bloomberg/ICMA, respectively, with a nominal incentive provided to survey respondents. The survey was live from 30 January to 11 March 2024. ICMA performed the data analysis and drafted this report with technical support and thematic guidance from Bloomberg.

We received a total of 308 responses, with global coverage including EMEA, APAC, USA and Canada. Respondents were primarily from the financial services sector (83%), with coverage across a variety of institution types including asset management, commercial and investment banks, brokerage firms and others. A wide variety of functional areas and seniority levels were represented.

KTB Trading: Current Drivers and Dynamics

Drawn from a wide pool of international capital market participants, 91% of our survey respondents have never traded KTBs before. The remaining 9% have either traded in the past (6%) or are currently trading KTBs (3%).

Figure 1: Do you currently trade Korea Treasury Bonds (KTBs)?

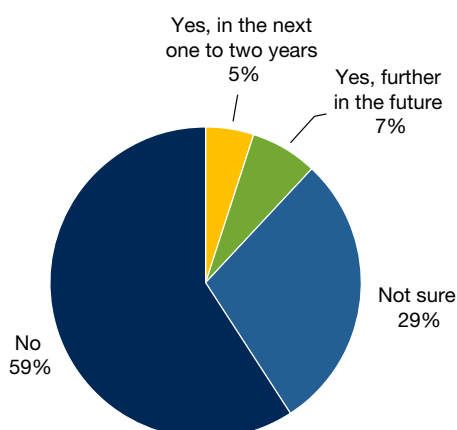


Source: Global Survey of Korean Treasury Bond Markets, ICMA & Bloomberg, 2024 (Base size: n=308)

The geographic distribution of those who have never traded KTBs before largely followed the proportion of the overall survey population, with the United States accounting for 20%, and Japan and the United Kingdom with 9% each. Those who have never traded KTBs were asked the follow-up question of whether they would consider trading KTBs in the future. Roughly only 10% of them replied yes, with the remaining answering no or not sure. For the latter group, they were subsequently asked to select all factors that would influence them to consider entering the KTB markets.

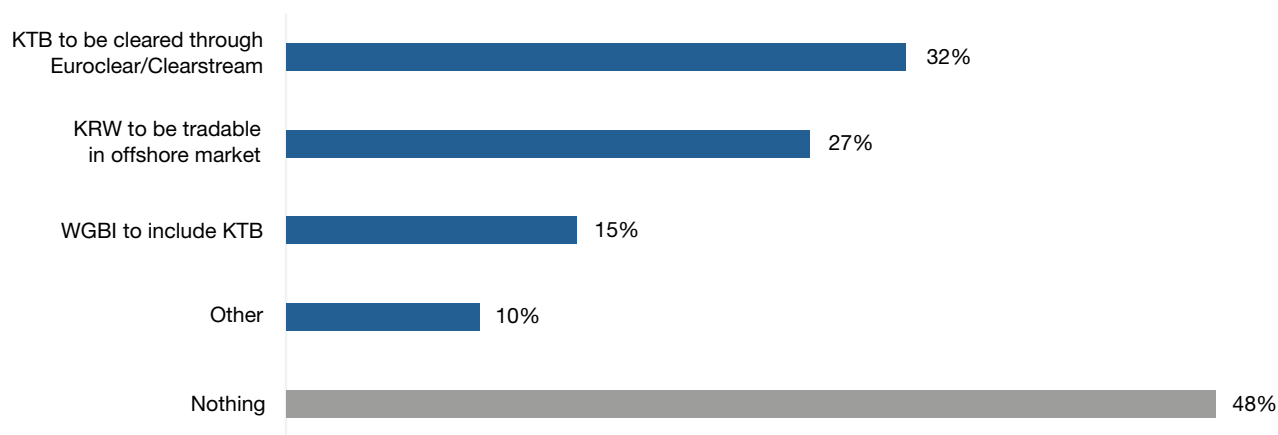
About one-third of those not currently trading KTBs said they would enter the market if KTBs were cleared through Euroclear or Clearstream. Almost as many (27%) said it will also be important for South Korean Won (KRW) to be tradeable in offshore markets.

Figure 2: Do you intend to enter the KTB markets in the future?



Source: Global Survey of Korean Treasury Bond Markets, ICMA & Bloomberg, 2024 (Base size: n=281)

Figure 3: What would need to happen in order for you to consider entering the KTB markets? Select all that apply.



Source: *Global Survey of Korean Treasury Bond Markets, ICMA & Bloomberg, 2024* (Base size: n=248)

Past KTB Traders¹

Survey respondents who are not currently trading KTBs but have in the past (6% of survey population) mainly ceased trading as a result of a change in their corporate/investment strategies, with some saying that the markets have insufficient liquidity to match their needs. Over 7 in 10 respondents also mentioned that they are unsure when asked if they would like to re-enter the KTB markets.

Potential KTB Traders

Survey respondents who have never or have only traded KTBs in the past and are interested to participate in the market (12% of survey population) cited portfolio diversification as the main reason for doing so, while other favourable market conditions such as higher liquidity and lower default risks were only looked at to a lesser extent.

Current KTB Traders

When asked about how they plan to change their KTB trading volume in the next one to two years, current KTB traders who responded to the survey (3% of survey population) cited a variety of reasons, the most common being portfolio diversification and lower default risk. Most of them, however, also indicated no plans to increase their trading volume, citing limited hedging opportunities and difficulty to trade FX offshore.

Two-thirds of the group adopted an active investment strategy, with their most preferred way of trading KTBs roughly evenly divided between onshore brokers, custodians and onshore dealers.

¹ Given the limited base size, the survey results for the following three subgroups are intended for reference only and may not fully reflect the views of the corresponding market population.

Reform Impacts: Regulation and Liquidity

At the time of this report's publication, South Korea remained on the FTSE Fixed Income Country Classification watch list for consideration for inclusion in the FTSE WGBI since it was first named on the watch list in September 2022. At the same time, South Korea has not yet been included on MSCI's watch list for a potential reclassification from an Emerging Market (EM) to a Developed Market (DM) status².

Nevertheless, progress toward these milestones have been concrete and significant, as a number of market reforms relevant to KTB trading have been implemented over the past few years.

Table 1: Key market reforms in the Korean capital markets

Time	Scope	Details
January 2023	Tax	Non-taxation for foreign investors' government bond investment income implemented
August 2023	Connectivity	Korea Securities Depository (KSD) signed contracts with Clearstream and Euroclear to establish a link between them
December 2023	Registration	Trading with Legal Entity Identifier (LEI) started for new foreign investors, following abolishment of the Investor Registration Certificate (IRC) ³
June/July 2024	Connectivity	Omnibus accounts opened for government bonds linked with ICSDs
July 2024	FX	Foreign FIs allowed to participate in the onshore FX markets, with trading hours extended to 2 am of the following day (previously from 9 am to 3:30 pm)

Source: ICMA & Bloomberg market research and analysis

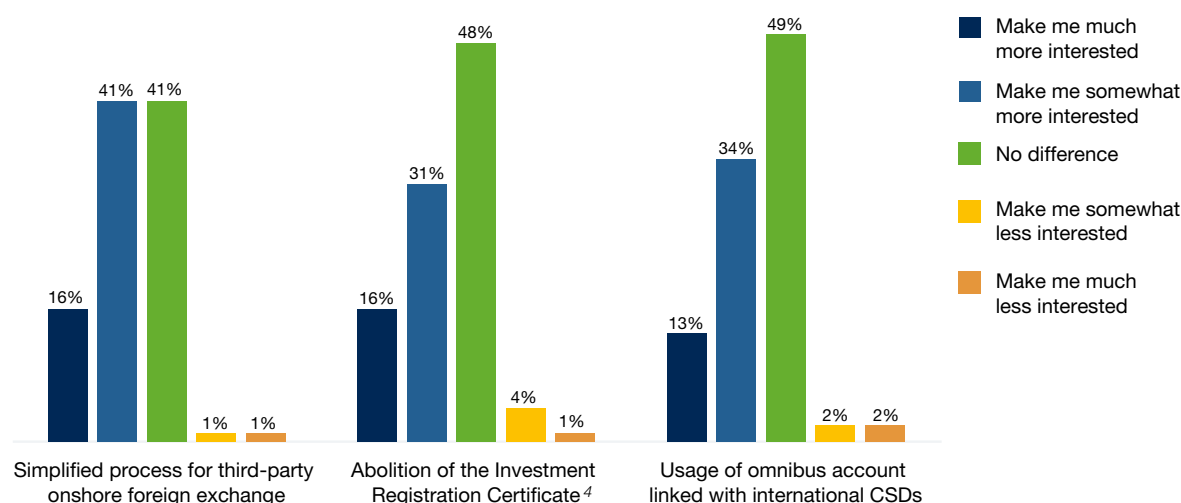
Having taken into account these key market reforms, we designed the survey around three specific initiatives (ie simplified process for third-party onshore foreign exchange, the abolition of the IRC system, and the usage of omnibus accounts linked with ICSDs).

Among these, more than half of respondents (57%) said that operational reforms focused on simplifying the process for third-party onshore foreign exchange would increase their interest in trading KTBs. Other reforms addressed in the survey also looked likely to increase interest in KTBs among a notable portion of the investor community. These include the abolition of the Investment Registration Certificate (47%) and the usage of omnibus accounts linked with international CSDs (47%).

² The latest results of the MSCI 2024 market classification review were announced on 20 June 2024 – accessible at <https://www.msci.com/documents/10199/aa6d80a3-9bc4-4f98-9b7d-02f985826daf>

³ "Those already assigned a foreign investor ID can continue to use their investor registration number so that potential inconvenience caused by changing the system can be minimised" as quoted from FSC's press release - accessible at <https://www.fsc.go.kr/eng/pr010101/80123>

Figure 4: How would the following operational reforms impact your interest in trading KTB?

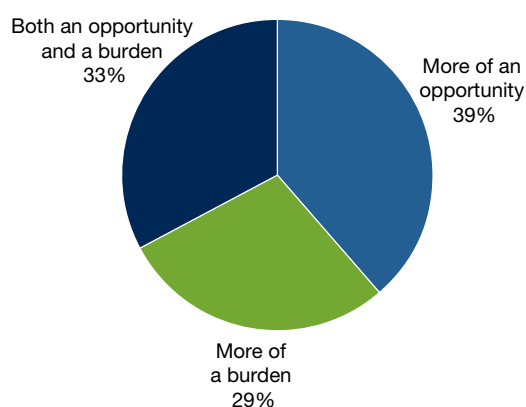


Source: Global Survey of Korean Treasury Bond Markets, ICMA & Bloomberg, 2024 (Base size: n=308)

The survey included a question about the IRC-LEI registration system. According to current guidelines from the revision bill of the Enforcement Decree of the Financial Investment Services and Capital Markets Act (FISCMA), new offshore KTB investors without an IRC would need to trade with their LEI, while existing offshore traders would be required to continue using their IRC for KTB trading.

About a third of survey respondents considered it as more of an opportunity as they would no longer need to apply for an IRC. However, another third viewed it as more of a burden due to perceived increases in compliance costs. Given the mixed result, further market feedback needs to be gathered to better gauge the impact of the IRC-LEI registration system reform on the KTB markets.

Figure 5: How would you describe the impact of the change in the IRC-LEI registration system?



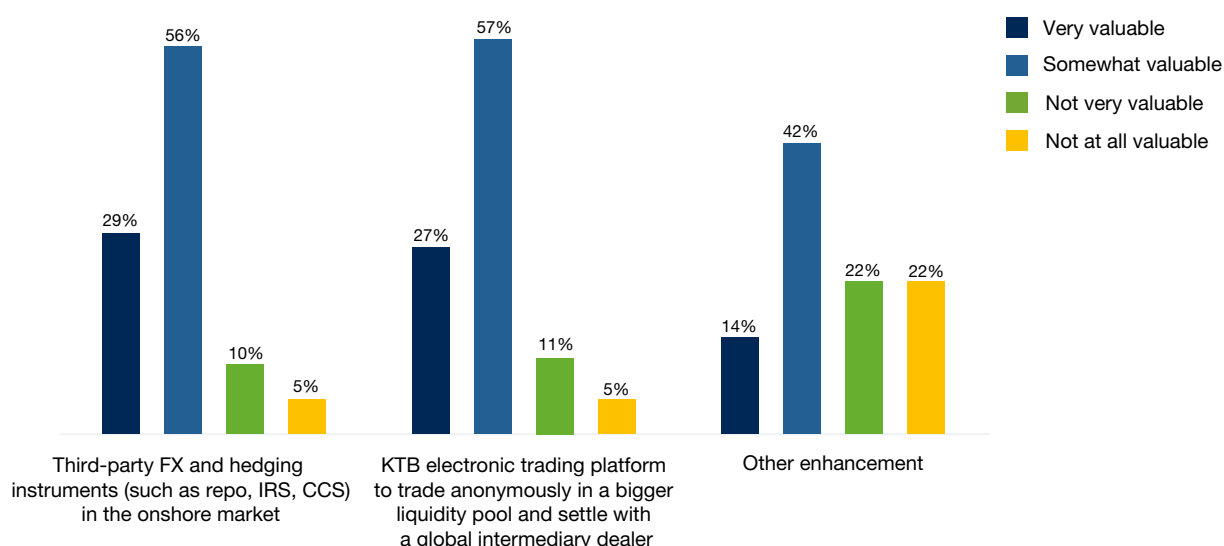
Source: Global Survey of Korean Treasury Bond Markets, ICMA & Bloomberg, 2024 (Base size: n=255)

4 Please refer to footnote 3

Looking Ahead: E-Trading and Index Inclusion

Among enhancements for trading KTBs, third-party FX and hedging instruments (85%) and electronic trading platform to enable anonymous trading in a bigger liquidity pool (84%) were seen as most valued by survey respondents. Respondents also told us that they are looking for more liquidity and transparency in the KTB repo markets, less volatility in the currency and greater pricing transparency of KTBs.

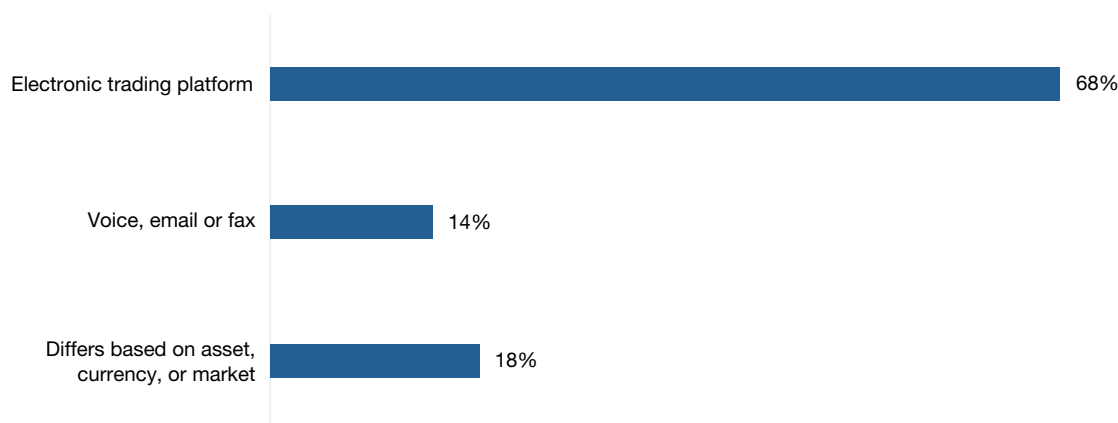
Figure 6: How valuable would you find each of the following for trading KTBs?



Source: Global Survey of Korean Treasury Bond Markets, ICMA & Bloomberg, 2024 (Base size: n=308)

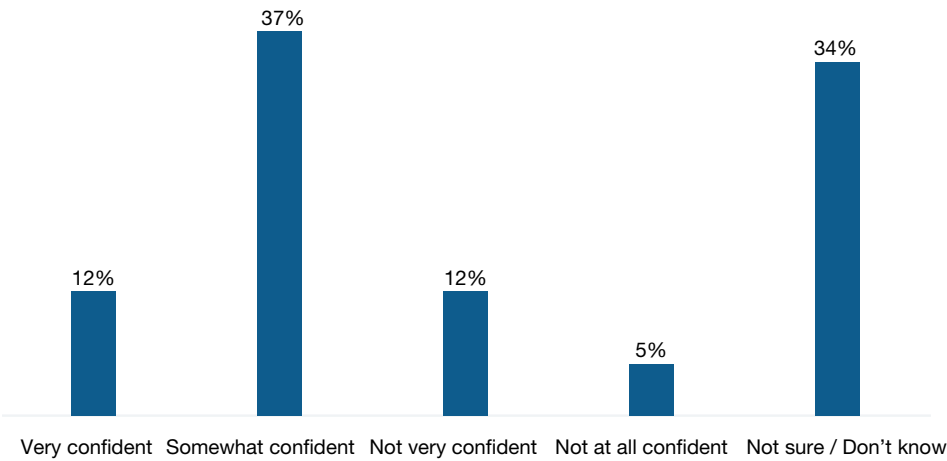
While the majority of respondents (68%) preferred electronic trading platforms for their overall trading activities, less than half were confident that existing electronic trading platforms can efficiently connect the KTB markets to global investors.

Figure 7: For bonds across your portfolio, what is your preferred trading method?



Source: Global Survey of Korean Treasury Bond Markets, ICMA & Bloomberg, 2024 (Base size: n=308)

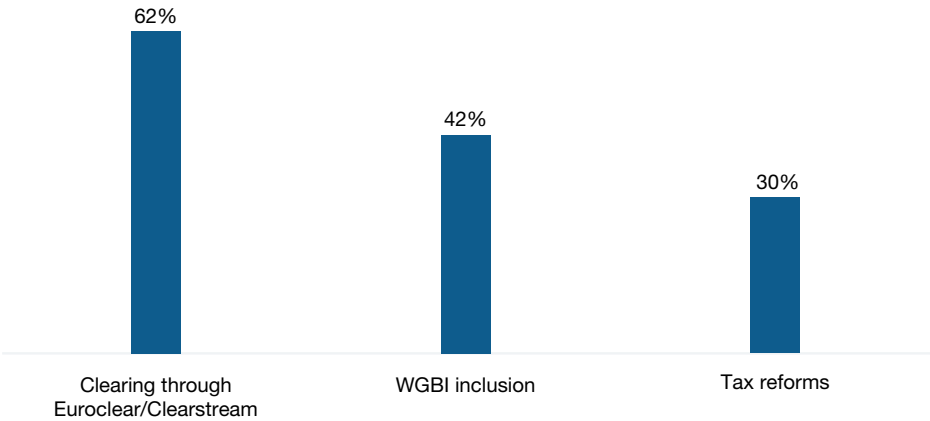
Figure 8: How confident are you that existing electronic trading platforms can efficiently connect the KTB markets to global investors?



Source: Global Survey of Korean Treasury Bond Markets, ICMA & Bloomberg, 2024 (Base size: n=308)

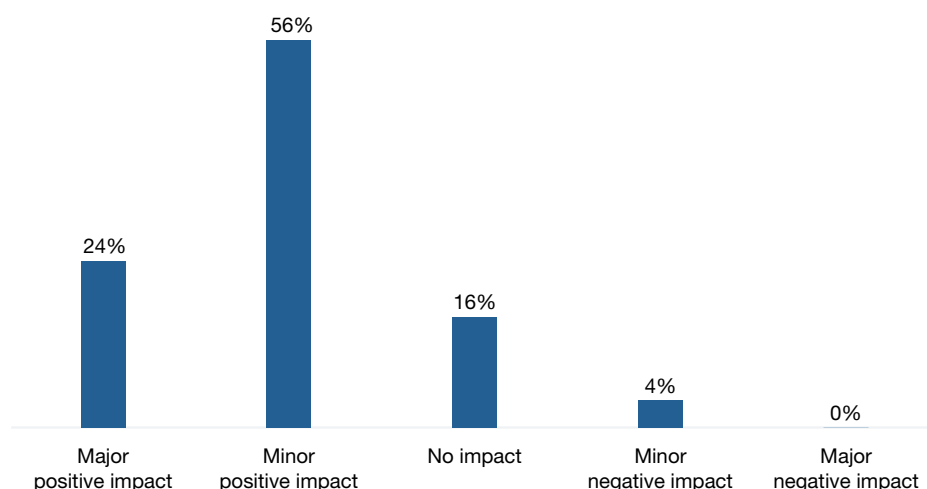
In terms of trading volume, a majority of respondents (62%) said that having KTBs cleared through Euroclear or Clearstream would drive an increase in trading volume. Many also said that inclusion of KTBs on the World Government Bond Index would be a key driver. When asked about the impact of this specifically, 80% said that WGBI inclusion would be a net positive for the KTB markets. To a lesser extent, some also saw tax reforms as having potential to drive higher KTB volumes.

Figure 9: Thinking about the KTB markets, which do you see as the likely main drivers for trading volume increases in the next 12 months? Select all that apply.



Source: Global Survey of Korean Treasury Bond Markets, ICMA & Bloomberg, 2024 (Base size: n=308)

Figure 10: What impact do you expect World Government Bond Index (WGBI) inclusion to have on the KTB markets?



Source: Global Survey of Korean Treasury Bond Markets, ICMA & Bloomberg, 2024 (Base size: n=308)

Common Themes in Suggestions for Reform – Comparing Index Provider Criteria and the ICMA - Bloomberg Survey

As of this report's publication, South Korea remained in consideration for inclusion in the FTSE WGBI, as well as for reclassification by MSCI from EM to DM⁵.

Given that recent reforms have been and continue to be influenced by inclusion in the relevant indices, we prepared a summary below comparing areas of potential improvements in the South Korean bond market as cited by FTSE, MSCI, and our survey. The index inclusion criteria are based on the FTSE Fixed Income Country Classification Process⁶ and the MSCI Market Classification Framework⁷.

5 Accessible at - <https://www.msci.com/documents/10199/aa6d80a3-9bc4-4f98-9b7d-02f985826daf>

6 Accessible at - https://www.lseg.com/content/dam/ftse-russell/en_us/documents/country-classification/ftse-fi-country-classification-process.pdf

7 Accessible at - <https://www.msci.com/documents/1296102/6be059c3-16e9-7a8a-0ff2-0084fbbd7ae5>

Table 2: Comparison of areas for further improvement according to FTSE/MSCI and the ICMA-Bloomberg Survey

Areas	FTSE	MSCI	ICMA-Bloomberg Survey
1. Market, Macroeconomic and Regulatory Environment			
No Undue Investment Restrictions on International Investors	✓	✓ (Short-selling)	✓ (Short-selling)
Investor Registration & Account Set Up		✓	✓
Sound Regulatory Environment	✓		✓
Stability of Institutional Framework			
Transparent FX Policy and Communication	✓		✓
Taxation Regime Not Burdensome to International Investors	✓		✓
Information Flow		✓	✓
Transferability ⁸		✓	✓
2. Foreign Exchange Market Structure			
Sufficient FX Liquidity and Investability	✓	✓	✓
No Overly Prohibitive Currency Restrictions for Investment Purposes	✓	✓	
Currency Hedging Onshore or Offshore using non-deliverable forward (NDF) with Limited Divergence to Onshore	✓		✓
3. Bond Market Structure			
Competitive Transaction Costs	✓		✓
Liquidity			✓
4. Global Settlement and Custody			
Settlement Accommodative of Global Investors	✓	✓	✓
Competitive Custody Market	✓		✓
5. Openness to Foreign Ownership			
Foreign Room Level ⁹		✓	
Equal Rights to Foreign Investors		✓	
6. Technology Advancements			
			✓
7. Others			
Availability of Investment/Hedging Instruments		✓	✓

⁸ Refers to the ability to conduct off-exchange transactions and "in-kind" transfers as defined in the MSCI Global Market Accessibility Review. Accessible at - <https://www.msci.com/documents/1296102/a37efcf1-4584-6114-ca20-6ca94f1acbc0>

⁹ Refers to the proportion of shares available for non-domestic investors; existence of a foreign board where non-domestic investors could trade with each other, as defined in the MSCI Global Market Accessibility Review. Accessible at - <https://www.msci.com/documents/1296102/a37efcf1-4584-6114-ca20-6ca94f1acbc0>

As the KTB markets continue to evolve, survey respondents shared many other suggestions for continued improvement of the markets related to both accessibility of trading and market structure.

On ease of trading:

- Lowering of capital restrictions to encourage wider investor participation
- Enhancement of price discovery mechanisms to provide more transparent pricing information
- Establishment of competitive fee structures for cost-effective trading
- Product innovations including inflation-linked KTBs, green bonds for sustainable investment, bonds targeting retail investors, and USD-denominated KTB and KTB futures
- Gradual removal of the temporary ban on stock short selling

On market infrastructure:

- Implementation of delivery-versus-payment (DVP) clearing arrangement with custodians to streamline the settlement process and reduce settlement risks
- Integration of electronic all-to-all (A2A) systems for the KTB markets
- Competency of onshore repo brokers to directly engage with global investors (complementing offshore trading via ICSD omnibus accounts)
- Promote the use of the Global Master Repurchase Agreement (GMRA) for onshore and cross-border repo trades
- Special trading regions for offshore entities to establish hubs with designated legal status

Though not all of these proposals will be relevant to all investor-types, together they demonstrate both the range of stakeholders as well as the untapped opportunities to enhance the market for global investors.

About ICMA

ICMA promotes well-functioning cross-border capital markets, which are essential to fund sustainable economic growth. It is a not-for-profit membership association with offices in Zurich, London, Paris, Brussels, and Hong Kong, serving over 620 members in 68 jurisdictions globally. Its members include private and public sector issuers, banks and securities dealers, asset and fund managers, insurance companies, law firms, capital market infrastructure providers and central banks. ICMA provides industry-driven standards and recommendations, prioritising three core fixed income market areas: primary, secondary and repo and collateral, with cross-cutting themes of sustainable finance and FinTech and digitalisation. ICMA works with regulatory and governmental authorities, helping to ensure that financial regulation supports stable and efficient capital markets.

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