



South Korean covered bonds: A perfect tool to diversify investment and funding sources

Until now, few Asia-Pacific governments have encouraged covered bond issuance in the region. This could start to change, however, now that South Korea is planning to develop further its capital markets.

As volatility and uncertainty continue in global capital markets, the benefits of covered bonds – whether as enhanced security to the investor or lower interest rates to the issuer – are well-known.

Recognising this, the Australian government has recently approved the regulatory framework for off-shore/on-shore covered bonds to be issued there and is in the process of considering approval for domestic only covered bonds.

Now, South Korea has a chance for its capital markets to evolve and mature. It presents an opportunity for issuers to diversify their funding sources at relatively attractive rates – mirroring the opportunity for international investors to diversify into an attractive market.

South Korea - sound economic fundamentals

Since the subprime crisis, much of Asia-Pacific has been a safe haven. South Korea, in particular, has many attributes which attract foreign investors. The country's GDP growth last year exceeded 6%, driven by its large export growth engine – the country is the world's sixth largest exporter. As well as low unemployment, the country has substantial foreign exchange reserves.

This appeal is reinforced by signs that the South Korean capital markets are still maturing – as highlighted by the nascent development of a covered bond market. Signs of this appeared recently with Asia(ex-Japan)'s first three covered bond issuances – all out of South Korea.

Drivers of the market – the experience so far

The recent experience of the Korean Housing Finance Corporation (KHFC), which issued a \$500m covered bond not long ago, highlights some of the benefits that issuers and investors can expect in this maturing market. KHFC, a government-owned institution that provides housing finance to low- and medium-income borrowers, is the only institution in South Korea with a legislative framework that lets investors take statutory priority over the cover assets.

Covered bonds

An efficient, cost-effective way to raise funds or refinance whenever it is necessary to retain control of the underlying asset pool.

Covered bonds are fully secured or “covered” by an asset pool that remains on the balance sheet of the originator. The pool equates to at least the issue amount outstanding, while credit enhancement is available through overcollateralization.

Investors have recourse against the originator and the mortgage pool

Issuer / underwriter benefits

For the issuer, covered bonds provide an efficient and relatively low cost means of financing. The fact that the bonds are secured against underlying assets means that they generally pay lower interest rates.

The issuer can also benefit from investor diversification, as the distinct characteristics of covered bonds may appeal to certain kinds of investors who would not otherwise seek exposure to corporate bonds.

Investor benefits

Among the characteristics that allow investors to benefit from a substantially safer fixed income instrument are maximum loan-to-value thresholds, dual recourse provision, and preferential treatment in the event of a default.

Its recent issuance – its second following its debut issue last year – achieved an order book of \$1.5bn, representing 121 investors, with US and Asian investors taking up 41% each.

Investor demand was broad-based, both in terms of geography and institution type. Within Asia, Singaporean investors bought 15%, Korean investors 4%, Japanese investors 5%, Hong Kong investors 16%, and Chinese investors 1%. Australian investors accounted for 7%, while European investors took up 11% of the deal.

By investor type, fund and money managers bought 47%, banks 36%, insurers 9% and central banks/governments 3%. Corporates and private banks took up 5%.

Why was this issuance so attractive to such a broad spectrum of international investors?

In volatile markets, South Korea has become another destination in the flight to safety, as international investors search for defensive and secured structures. Not only does South Korea have sound economic fundamentals, but – in contrast to many developed economies – it has a relatively secure mortgage market. The government is strict on mortgage issuances, so residential mortgage-backed securities are viewed as safe. Such security is attractive in today's volatile markets: KHFC's most recent issue is rated Aa3 by Moody's – which is one notch above the Korean sovereign's A1 rating.

Consequently, there is a symmetry to these bonds' appeal: given their attractions to the international investor and their diversification potential, the investor base for covered bonds is likely to be predominantly offshore. For issuers, meanwhile, being able to diversify by geography and investor-type is a truly attractive way to fund themselves in the market.

Domestic market – the primary driver of change

Despite the obvious attractions to international investors, the primary driver of change is domestic. The development of a covered bond market in South Korea provides local issuers with the opportunity to issue cross-border.

This represents another key opportunity for South Korean capital markets to evolve and mature and add another

product of substance to local issuers' ability to diversify their funding sources. Korea provides local issuers with the opportunity to issue cross-border. This will allow them to capture new, diversified sources of funding. Also, because of the secured nature of this form of mortgage funding, (bank deposits will not be allowed), it is at more attractive rates.

This is a unique opportunity whereby the need for issuers to diversify their funding sources is mirrored by the opportunity for investors to diversify their investments.

The next steps

The lack of a legal and regulatory framework is the main reason covered bonds are not actively issued in South Korea. In the current environment, banks that meet the requirements have to pay high commission fees to various parties in order to structure covered bonds. The financial regulator has suggested guidelines for covered bonds, implying that it is keen to develop this side of the South Korean market.

Nonetheless, the industry is still waiting for new regulation to allow a standard covered bond to be able to compete with its European counterparts. If the success of KHFC's recent issuance is a bellwether, the industry is hopeful that South Korea's National Assembly and regulators will soon open the door to higher volumes of covered bond issuance by others.

Wider covered bond issuance is not the only capital market development under consideration by South Korea's National Assembly. Although it has not yet passed the required tax legislation to support the development of the Sukuk market, industry participants are hopeful that the necessary legislation and regulation will crystallise in the not-too-distant future.

Together, these measures suggest the country's legal and regulatory regimes are intent on building out issuers' fund raising capabilities. With BNY Mellon's long history of actively servicing covered bond markets around the world, we believe South Korean covered bonds have the potential to be a successful source of funding for Korean issuers – and a welcome means of diversification for international investors.



John-Paul V. Marotta
Managing Director
BNY Mellon Corporate Trust
j.p.marotta@bnymellon.com
+852 2840 6633



Suk Kyu Lim
Vice President & Head of Global Issuer
Services BNY Mellon Korea
sukkyu.lim@bnymellon.com
+822 399 0040



Ki Un Na
Vice President
BNY Mellon Corporate Trust Korea
kiun.na@bnymellon.com
+822 399 0356