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Press Release

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PLANS TO ENHANCE THE SHORT-TERM FINANCING MARKET

Current Status-quo of the Short-term Financing Market

By short-term financing, we mean wholesale financing among financial institutions by trading or issuing under 1- year maturity products such as Calls, RPs, CPs, and CDs.

<u>An analysis of current situation by individual market sectors</u>

① (Call Market) Daily average volume of KRW 33 trillion*, which takes up about 50% of the short term financing market.

*Reduced down to KRW 11 trillion level, but recently resumed to the pre-crisis level. ('08.9: KRW 29 trillion, '09.3: KRW 11.5 trillion, '09.12: KRW 30.2 trillion, '10.6: KRW 33.1 trillion)

② (RP) Trading volume (outstanding balance base) has been consistently growing. ('07: KRW 65 trillion, '08: KRW 69 trillion, '09: KRW 72 trillion).
Most of the transactions (87%) are large client based.

③ (CD) Dropped to KRW 79 trillion level due to the curb on Loan-to-Deposit Ratio regulation, while market trading volume has gone down to KRW 4.5 trillion daily average.

Source: Bank of Korea

Problems Detected in the Short-Term Financing Market

The overriding problem in the short-term financing market is that it is too much concentrated on the Call market which causes distortions to the market function and may entail latent systemic risk.

- The convenience of Call transactions using credit based lending with high liquidity and low interest rate triggered the growing dependency of the Call market by financial institutions.
  - Composition of the short term financing market (as of May '10): Call (50.5%), RP (16%), CP (17.2%), CD (16.4%)

- The Call market's function has been misled as 'funding sources' for the secondary financial institutions' (e.g. securities houses and mutual savings banks) operating capital and in turn used to invest in high yielding short term KTBs.

- In particular, excessive 'call money' by securities houses could become a source of potential systemic risk when hit by a sudden credit crunch.

- The over-usage of the Call market also led to the underdevelopment of the RP market.
  - In most advanced countries, investment banks' active trading of RPs acts as a linkage between long-term and short-term bond prices, as well as spot and future bond prices.

- The inexistence of a short-term bench mark rate causes a deterrent effect to the qualitative and quantitative growth of the short term financial market.

Reforms to the Call Market

1. Short-term objective

   - Limit call loans to 100% of firm's equity capital (6-months grace period given)
   - Require firms to set up a risk management council

2. Mid-term objective

   - Strengthen liquidity requirements and NCR to limit the use of Call loans
   - Specifics of strengthen requirements be to confirmed after looking at the progress of RP market vitality and future outcomes from the G20 financial regulatory discussions

3. Long-term objective

   - Examine the need for the transformation of the Call market to an interbank market

RP Market Revitalization

1. <u>Improvement of RP transaction infrastructure</u>

A. Introduction of a central clearing system for RP transactions
(end-2011, improvement of the Korea Securities Depository's (KSD) RP system)

(Present condition) RP transactions have been conducted piecemeal using the funds of individual asset management companies.

(Improvement) Where the custodian banks and asset management firms are identical, the improvement will make it possible to enter into RP transactions drawing on multiple funds.

B. Establishment of an OTC RP online transaction system
(end-2011, KSD's clearing function)

(Present condition) The linkage between the systems of brokerage firms and of the Korea Securities Depository has been inadequate.

(Improvement) First, the systems linking brokerages and the KSD will be set up, and over the long-term, an online transaction system providing counterparty search and asking price offer services will be available.

C. Promote the usage of standardized contracts for institutional RP transactions
(1H of 2011, by KSD)

(Present condition) Some parts of the KSD RP transaction system and related provisions differ from those in standardized contracts for institutional RP transactions.

(Improvement) Revised RP transaction system and related provisions* to adhere to the international standardized contracts

*Terms and conditions regarding disposal of eligible securities for RP transactions, and methods of margin implementation

D. Introduction of Securities Finance Corporation's function as an OTC RP market maker
(2H of 2010)

(Present condition) Owing to the sluggish development of the RP market, there have been difficulties in identifying counterparties matching each other's transaction terms and conditions, including maturities and securities for collateral.

(Improvement) The Securities Finance Corporation will be allowed to conduct RP transactions in the same way as dealers.

E. Support for securities lending of collateral for RP transactions
(2H of 2010, revision to the provisions of The Securities Finance Corporation)

(Present condition) Small and medium-sized non-banking companies have suffered from a shortage of collateral eligible for RP transactions (government and public bonds).

(Improvement) The scope of the implementation guarantees for securities lending transactions by the Securities Finance Corporation will be enlarged.

- The scope of collateral for implementation guarantee:
  (Present condition) cash and bonds with AA and higher ratings
  (Improvement) stocks and Mezzanine bonds

2. <u>Expansion of institutional RP transactions</u>

A. Specification of the criteria for exemption from RP cross trading among funds (2H of 2010, establishment of model criteria)

(Present condition) As the criteria for allowing RP cross trading among funds are ambiguous, asset management firms have taken out 1-day call loans instead of RPs as capital requirements for fund redemption.

(Improvement) Inducement of conversion from call loans to RPs by limiting the criteria for allowing RP cross trading among funds to cases where there is no concern about yield manipulation.

B. Recognition for RP transactions when calculating MMF's aggregate trading ceiling on a single counterparty (2H of 2010, Financial Investment Services and Capital Markets Act)

(Present condition) In managing MMFs on the basis that the aggregate volume of securities issued by a single counterparty and transactions made with a single counterparty (deposits with financial institutions, short-term loans, and RP purchases) should not exceed 10% of the total fund resources, RP transactions have been at a disadvantage compared to call loans.

- But, an exception is made for call loans maturing within 30 days extended to financial institutions with ratings in the two uppermost grades.

(Improvement) RP transactions will be excluded when calculating the single counterparty aggregate trading ceiling.

- However, to minimize counterparty risks, RP transactions will be strictly limited to those whose conditions are equivalent to those of call loans.

C. Restriction on customer RP transactions (RP type CMA) among financial firms (2H of 2010, Enforcement Decree of the Financial Investment Services and Capital Markets Act)

(Present condition) Due to the convenience of customer RP transactions, financial institutions have entered into them instead of institutional RP transactions.

(Improvement) So as to expand the institutional RP market, only funds entrusted to financial firms will be eligible for use in customer RP transactions.

D. Increase the ratio of institutional RP transaction performance reflected in selecting eligible financial institution counterparties for RP transactions with the BOK [This will be reflected starting from 2011(transaction volumes from Aug. 2010 ~ Jun. 2011), the Monetary Policy Committee].

(Present condition) Since 2008, the Bank of Korea has reflected institutional RP transaction volumes when selecting the eligible RP counterparties with the BOK. (5% for existing institutions and 65% for newly institution applicants)

(Improvement) The reflection ratio will be increased.

3. Formation of benchmark short-term bond rate

A. Introduce and foster a benchmark short-term bond

Issue short-term KTBs up to the standards to be represented as the benchmark short-term bond after making relevant revisions to the National Finance Act.

- Currently, any increase in the total issuance amount of KTBs needs to be approved by the National Assembly.

B. Until then, BOK's currency stabilization bonds to be used as the benchmark bond rate

91-Day currency bond: raise the issuance to KRW 1.0 ~ 1.5 trillion per week
182-Day currency bond: start with issuance of KRW 0.5 trillion bi-weekly and expand

Timeframe

- Reforms to the Call market: *within 3Q10*

- RP Market Revitalization: *make regulatory changes within 2010 and implement in 2011, with the exception of KSD electronic network enhancements to be taken throughout 2011.*

- Formation of benchmark short-term bond rate
  - Regular issuance of BOK's currency stabilization bonds: *as of now*
  - Issuance of short-term KTBs: *make changes to the National Finance Act within 2011 and start in 2012*

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