THE MARK-TO-MARKET SYSTEM AND ITS IMPACT

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The introduction of a mark-to-market valuation system for funds managed by investment trust companies (ITCs) is scheduled for July 1, 2000. This article introduces the new system and considers its impact on the Korean economy.

Starting the mark-to-market valuation system

The mark-to-market valuation system was implemented in two stages. The first stage started on November 15, 1998. The funds -excluding Money Market Fund and Money Market Deposit Accounts- that were launched after November 15 1998 were included in the new valuation system. The book value system holds for funds launched before November 14 1998, so those funds no longer have any effect on customers.

The second stage of the new system will start from July 2000. Table 1 summarizes the changes of the bond valuation system.

Table 1. Summary of bond valuation method

Category	Type	Valuation Method	
		Current	After July 2000
Book-valued Fund	Launched before Nov.14,1999		
	-Except regular saving fund	Book value	Book value (Stop new trust assets after July 2000)
	-Regular saving fund	Book value	Book value (New trusts after July 2000 : Market value)
	MMF	Book value	Book value
Market-valued Fund	Launched after Nov. 15, 1998	Market value	Market value

Source: Financial Supervisory Service

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So far, bonds have been valued at book prices rather than at market prices. So bond yields have been calculated according to interest rates at the time of issuance. But under the new system, yields on bonds held by ITCs will reflect interest rates on a daily basis, directly affecting the return on bond-related funds. Therefore, investors will perceive bonds as a means of investment rather than savings.

Table 2. Book-valued bonds vs. Market-valued bonds

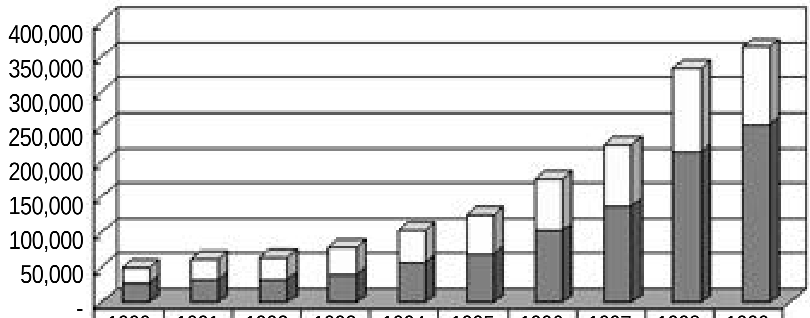
	Book-Valued Bond	Market-Valued Bond
Concept	For Saving	For Investment
Operation Method	Hold to Maturity	Trading
Security of Principal	Mostly secure	Not secure

Listed bonds are evaluated by the market price of the KSE and non-listed bonds are evaluated by all banks and the Bond Evaluation Committee of an ITC according to the benchmark rate (the base yield of bonds for assessing market value) offered daily by the Korea Securities Dealers Association.

From 1990 to 1999, Korea's bond market grew from 51 trillion won to 364 trillion won, but its quality has not made much improvement. The mark-to-market valuation system was introduced to keep up with the pace of progress and to attract more foreign investment.

Figure 1. Size of The Bond Market

(unit : billion won)



	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Corporate Bond	22,068	29,241	32,697	37,574	45,876	56,456	73,120	86,024	119,43	11,112
Public Bond	29,049	32,250	32,447	41,359	56,620	69,542	10,241	13,809	214,60	25,329

Source : Korea Investment Trust Companies Association

Impact on the Korean economy

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If the investors who had perceived ITC managed funds as investment funds demand a mass redemption out of concern of a valuation loss, ITCs will have to sell their bonds to cover the redemption capital. This will cause a rise in interest rates and decline of bond prices, which will eventually lead to the acceleration of breakaway investment funds.

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In the banking sector, bank-managed funds are already evaluated by their market value, and adjustment of bad loans reduced 1999's year-end bad loans by 9.3 trillion won compared to 1998. The total credit bad loan ratio was 5.1 percent, down by 2.5 percent from the year before. This has made it possible for less shock than the ITCs.

Table 3. Bad loans of Banks

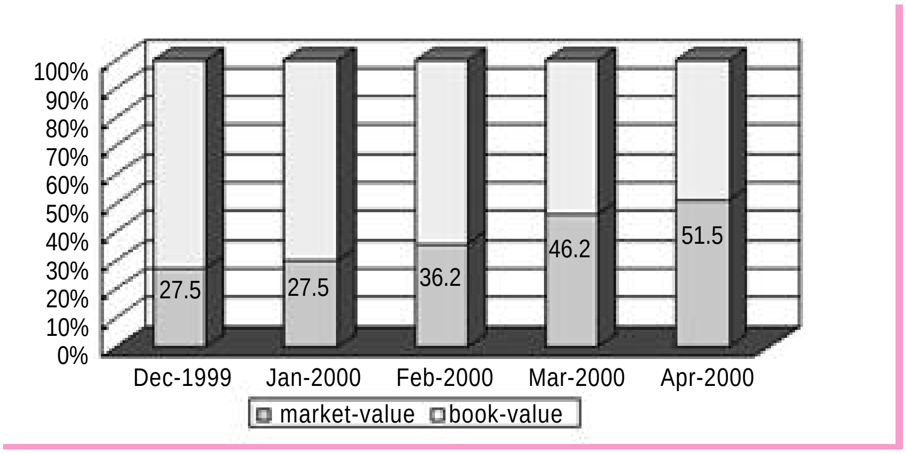
(unit : trillion won)

	Dec.1998 (A)	Sep. 1999 (B)	Dec. 1999 (C)	Increase C-A	Increase C-B
Total Credit (a)	443.4	455.9	474.0	30.6 (6.9%)	18.1 (4.0%)
Bad Loans (b)	33.6	30.1	24.3	-9.3 (-27.7%)	-5.8 (-19.3%)
Ratio(b/a)	7.6%	6.6%	5.1%	-2.5%	-1.5%

Source : Financial Supervisory Service

As of May, nearly 57 percent of total funds were valued on their market value, while the remaining funds were valued on their historical prices. Since the latter will maintain their valuation system, insolvency of ITCs is highly unlikely.

Figure 2. Percentage of Market Valued Bonds of the ITCs

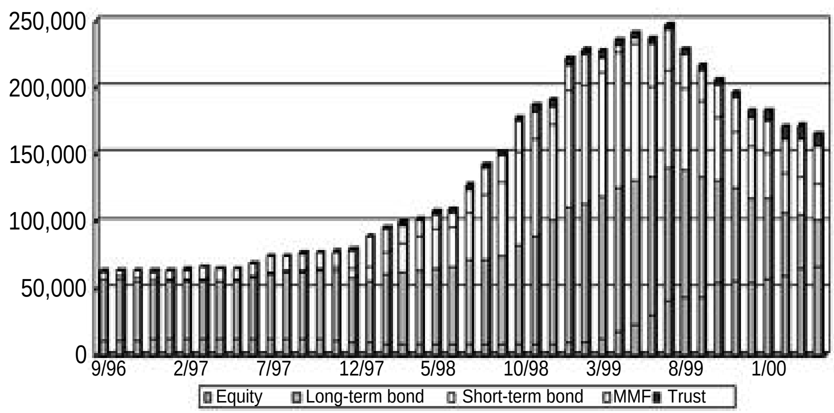


Source : Financial Supervisory Service

Demand for bond-type funds has weakened because investors are worried about realization losses with the introduction of the market price valuation scheme. There are also concerns that the new system may face some difficulties owing to the immature bond market. This trend will continue until the mark-to-market system settles in.

Figure 3. Composition of ITC

(unit: billion won)



Source: Korea Investment Trust Companies Association

The government is pursuing several measures to expand the market base of Korea's investment-trust industry and to support ITCs. The government intends to ease the cash crunch at local businesses and induce a soft-landing of the mark-to-market valuation system. The government plans to secure some six trillion won in long-term, low-interest rate state bonds by July to provide emergency cash to ITCs in the event of a liquidity crisis following the launch of the new valuation system. To help alleviate uncertainties in the local money market, the government will allow ITCs to sell tax-free products starting July. In addition, the government is permitting them to sell closed-end mutual funds starting mid-June and semi-open-end mutual funds beginning in July.

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Under the book-value evaluation system, when the value of bonds fall as a result of rising market interest rates, asset management firms have to dilute losses by transferring them to profitable assets in order to make interest payments as promised. But the new system will resolve this loss transferring because investors will suffer losses.

A mark-to-market valuation system will provide investors with realistic information to assess borrowers' assets and liabilities and to predict credit risks. Thus, investors will move from poorly-managed to well-managed funds. It is expected that good ITCs will attract more funds while inefficient ITCs will lose funds. Therefore, fund managers and ITCs must develop the skills to predict interest rates and enhance a risk management system to prevent the value of their bond holdings from falling.

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In conclusion, this new system may cause a liquidity shock in the short-run, but in the long run, a new Korean market will emerge and become more globalized. This trend will raise the efficiency of the bond market and will greatly contribute to building a competitive financial market, improving financial techniques, and attracting more investors. VIP