PROGRESS OF THE MARK-TO-MARKET BOND VALUATION SYSTEM

Eun-Ju Lee
(ejlee@hri.co.kr)

Introduction

In return for bailout loans in 1997, the government promised the International Monetary Fund that it would switch to a mark-to-market bond valuation system starting July 2000. This system, which was implemented in two stages since November 1998, is said to be one of the attempts to improve the local bond market and to resolve the insolvencies of banks and investment trust companies (ITCs).

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It has been about seven months since the system was introduced on a full scale. Although it is too early to assess the effects of the system, it appears that much effort has been made to invigorate the bond market and change investors' consciousness. These changes will be the first step for the development of the capital market in a broad sense.

Mark-to-Market Valuation System

The mark-to-market valuation system differs from the book-value system in that bonds are valued by market prices. Under the mark-to-market system, yields on bonds held by ITCs reflect interest rates on a daily basis, directly affecting the return rate on bond-related funds. Outstanding bonds with an active secondary market are valued at market prices in exchanges. Non-activated bonds lacking an active secondary market are evaluated at fair values which are estimated with maturity yields assumed from matrix pricing tables of the Korea Securities Dealers Association. That is, we add the risk premium of each bond on the maturity to the maturity structure of index bond yields such as non-default yields- treasury bonds or governance bonds.

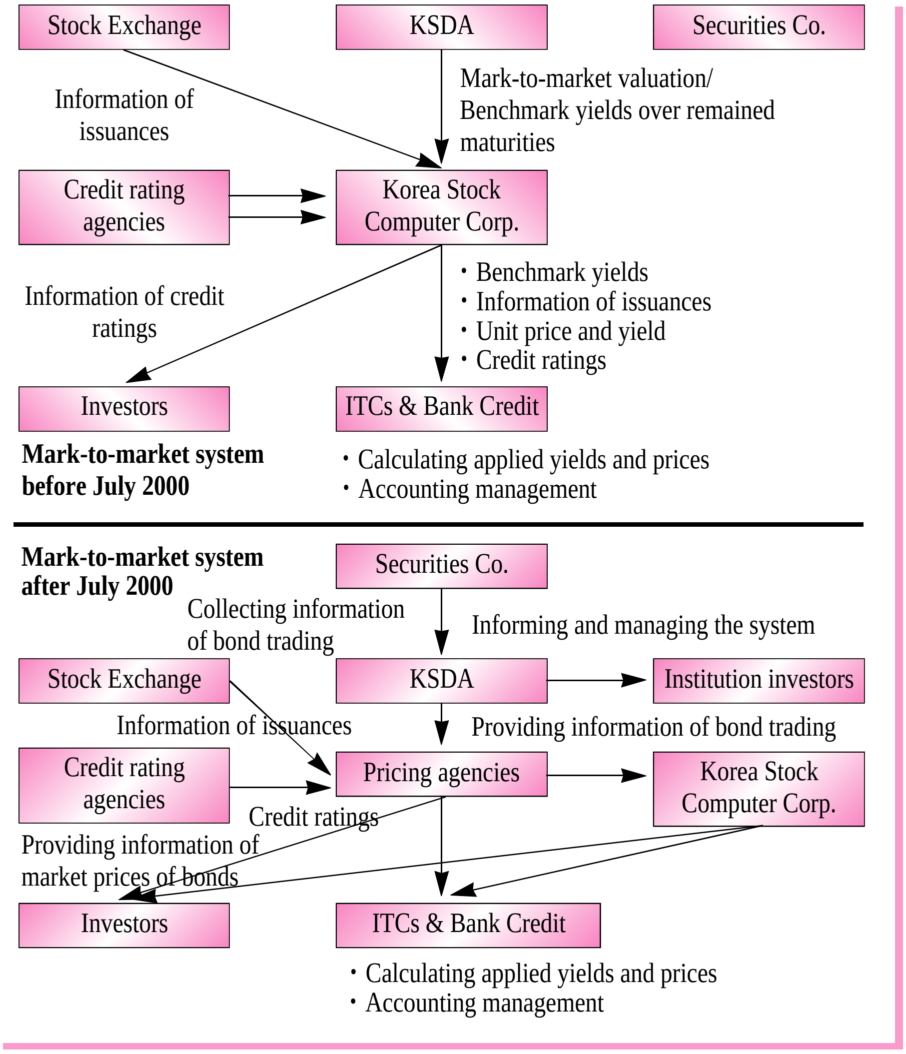
The introduction of the new accounting mode is essential to expanding the market's liquidity.

The introduction of the new accounting mode is essential to expanding the market's liquidity, the lack of which blocks the development of an active secondary bond market. Bonds have so far been valued at book prices rather than market prices. In other words, the yields on bonds are calculated according to interest rates at the time of issuance.

With the introduction of the mark-to-market system, financial institutions must mark their investments to market in order to let bond prices fall as well as rise. The system can revive the market principle and boost investor responsibility. Moreover, contrary to the book-value system which fails to reflect a borrower's financial health, as was highlighted by the ailing Daewoo Group, market valuation of bonds will enhance the transparency of asset management in financial institutions.

The launch of the new valuation system can also enliven the secondary market

Figure 1. Structure of Mark-to-Market valuation system



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by attracting more foreign investment, which currently account for a negligible portion of the domestic market. Foreign investors have regarded book-value pricing of bonds as the biggest obstacle to investment in the local debt market. If the introduction of the market valuation system opens the way for more foreign participation in the secondary market, foreign investors are expected to emerge as a major buying force, helping to increase the demand base.

The new accounting method can also contribute to the creation of a market for bond-related derivatives

The new accounting method can also contribute to the creation of a market for bond-related derivatives, which will provide financial institutions with a tool to manage interest-rate risks, encouraging them to engage in rational asset management and develop various new financial products. In addition, mark-to-market accounting will provide investors with realistic information for assessing borrowers' assets and liabilities, and for predicting credit risks. With the information of market prices, return rates on bond-related funds, such as beneficiary certificates, may vary among funds as well as management companies. In the end, it is possible that poorly managed funds might lose part of their principal and have difficulty in attracting investors.

Market Pricing Agencies and Bond Indexes

The introduction of bond pricing agencies is the groundwork for the mark-to-market assessment system.

Market pricing agencies are specialized companies which evaluate the market prices of bonds based on their fair values and accumulate all kinds of information about bonds. The introduction of bond pricing agencies is the groundwork for the mark-to-market assessment system. If the agencies carry out their function of assessing bonds, bonds will be rated accurately and objectively, not just at the time of issuance but also when they are in circulation. Moreover, they can reduce the social costs caused by instability of the bond market and settle the problems of information asymmetry to bonds.

An essential infrastructure of an active bond market is a bond index. Like stock indexes, bond indexes are benchmarks which indicate the fluctuation of yields on bonds in the market on a weekly or monthly basis.

The usefulness of bond indexes outweighs the difficulty in their development.

Unlike stock indexes, there is a lot of difficulty involved in developing and updating bond indexes because there are various kinds of bonds with various characteristics depending on maturity, class and issuer. However, the usefulness of bond indexes outweighs the difficulty in their development. By observing bond indexes continuously, investors are able to measure bond portfolio performances, make asset allocation decisions and replicate of performance of indexes for index funds. Bond indexes can also serve as a basis for derivative securities. After all, they can make it possible for investors to build timely strategies taking their asset portfolios into account, and promote the globalization of the financial market in Korea. Four

Table 1. Bond Pricing Agencies and Specialized Bond Dealers

	Bond Pricing Agencies	Bond Dealers
Requisites	· Dealing with bond pricing and related work · More than 3 billion won equity · More than 10 agents for valuation including 3 agents specializing in bond analysis · Should have equipment such as computer systems for bond pricing · Retain reasonable bond pricing models · The amount of investment should be less than 10% of equity in the case of conglomerates and financial institutions	· Securities companies with equity ratios exceeding 150% · Banks or finance companies with BIS ratio exceeding 8%
Institutions	· Korea Bond Pricing Corp., KIS Bond Pricing Co. and NICE Bond Pricing Co. specified for bond pricing (June 2000)	· 22 securities companies and 1 finance company, including Kyobo Securities, LG Investment Securities and Dongyang Finance appointed as special bond dealers (July 2000)

Table 2. Bond Indexes

	Samsung-Maekyung Index	KSDA-Bloomberg Index	Maekyung-Bloomberg Index	Hankyung-KIS Index
Cycle	Weekly, Monthly	Daily	Weekly	Daily
Process	Total return index	Total return index	Total return Index	Net price, Market price, Total return Index
Bond Pricing	From internal models	From yields on Committees	From yields on five securities companies	From bond pricing agencies
Composition of bonds	All Bond Index	Tracker Bond Index	Bellwether Bond Index	All Bond Index
Maturity	More than 3mths	More than 6mths	More than 6mths	More than 3mths
Credit ratings	Investment grades+ Speculation grades	Investment grades	Investment grades	Investment grades
Others	More than 100 mil. won amount of trading money	More than 5 bil. won amount of balances	For foreign investors	Adjusting return on reinvestments

bond indexes has been developed so far, which will be described in the following.

Effects of the new system

There are some different opinions about the effects of the new system so far. First of all, it is said that the market valuation system will help the workouts of financial institutions and promote invigoration of the bond market. The yields on bond-linked funds, based on mark-to-market valuation, exceeded 10% per year with a fall in interest rates, and individual and non-financial corporate investors didn't scramble to withdraw their funds as expected. Moreover, the efficiency of fund operations in ITCs has been improved by the new system. While there is a possibility that investors will be disturbed by the fluctuation of interest rates, this may be an essential aspect of a transition to an advanced capital market.

It is said that the market valuation system will help the workouts of financial institutions and promote invigoration of the bond market.

Meanwhile, some observers claim that the new system has not been working as expected, and has destabilized the bond market while confusing investors. Usually, bond yields based on market prices from Korea Securities Dealers Association or other pricing agencies fail to reflect the real state of the bond market, and the yields of some agencies tend to be lower or higher than those in the real market. People avoid buying bonds because there is a possibility of losses from different bond yields even at the very time of purchase. In addition, even yields on the same credit rating are different among agencies. This can impede the implementation of the mark-to-market system and, in the long run, the development of the bond market.

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However, considering the current state in which most investors have been gathering treasury bonds and government bonds and companies have difficulty in issuing bonds from lack of demand, activating the bond market through the market valuation system will not be an easy task. VIP