OPINION

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Structural Shifts in the Credit Bond Market in Response to Market Changes

The credit bond market in Korea has been recently undergoing structural changes, driven by various factors such as rising interest rates, supply-demand imbalances, and heightened credit risk. The increased volatility in interest rates has led to a sharp decline in average maturities of domestic credit bonds, prompting a surge in financing cost ratios. As evolving market conditions have increased refinancing instability, the issuance of floating rate notes (FRNs) has expanded during certain periods. In addition, credit bonds have been utilized not only for their primary purpose of capital raising but also for supplementing equity capital.

These structural changes in the bond market can be attributed to the financing strategies employed by credit bond issuers as well as changing market conditions. Despite various attempts to improve financing efficiency, the outlook for market conditions remains unfavorable. Persistent inflationary pressures defy market expectations, casting uncertainty over the timing of policy rate cuts. Even if interest rates drop, a return to the low interest rate environment is unlikely. Concerns about project financing (PF) defaults have barely abated, and some industries have experienced credit rating downgrades. Furthermore, the rise in financing cost ratios stemming from higher interest rates is likely to further strain corporate financial health.

To maintain the health of the credit bond market amidst these evolving conditions, it is crucial for credit bond issuers to enhance profitability, strengthen risk management, and improve financial stability. On top of that, policy support is needed to enhance stability in the credit bond market. Alongside macro-prudential policies, a robust financial support system should be established to swiftly address any market disruption event.

* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

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Since the major crash in the credit bond[1] market caused by the Legoland crisis in October 2022, the environment surrounding the market has been rapidly evolving due to a supply-demand imbalance resulting from large-scale issuance of Korea Electric Power Corporation (KEPCO) bonds, inflation-induced high interest rates, and increased credit risk in certain industries stemming from concerns over project financing (PF) defaults.

Recent changes in the financial market have affected the cost of financing and the feasibility of refinancing for credit bond issuers. In response, these issuers are making various efforts to improve financing efficiency by adjusting maturities and adopting various bond structures.

Against this backdrop, this article aims to understand how changing market conditions, such as rising interest rates, influence the credit bond market. To this end, it analyzes the distribution of credit ratings, the financing cost ratio,[2] maturity structures, and characteristics of domestic credit bonds. It also examines the major risk factors and potential countermeasures for the future credit bond market.

Issuance of credit bonds

Credit bonds are a primary financing tool employed by public enterprises, financial institutions, and non-financial companies. Despite the increasing financing costs resulting from global rate hikes, the issuance of credit bonds in Korea has been steadily rising. Credit bond issuance grew from KRW 234.4 trillion in 2015 to KRW 374.5 trillion in 2020, and saw a significant year-on-year increase to KRW 460 trillion in 2023. As this upward trend has continued well into the current year, the issuance volume reached KRW 188.1 trillion as of the end of May 2024, showing a slight year-on-year increase.

The growth in credit bond issuance has been mainly led by financial bonds. Annual issuance of financial bonds consistently increased from KRW 142.3 trillion in 2015 to 303.2 trillion in 2023, and this trend is continuing into 2024. On the other hand, the issuance of special bonds has shown variability year by year. In 2022 and 2023, there was a significant increase in special bond issuance, particularly driven by the expansion of KEPCO bond issuance. However, this year, the issuance of KEPCO bonds has almost ceased, resulting in a sharp decline in the issuance volume of special bonds compared to the same period last year. Corporate bonds

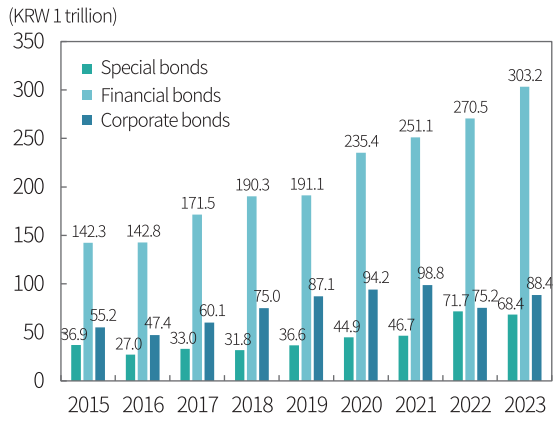
1) In this article, credit bonds refer to bonds with inherent credit risk, including special bonds, financial bonds, and corporate bonds.

2) The yield of bonds issued is defined as the financial cost ratio.

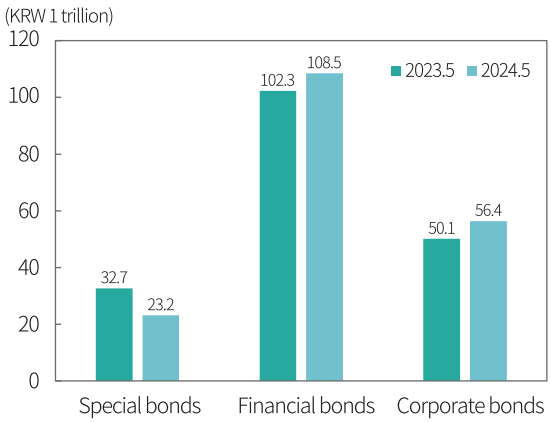
have also seen a steady rise in issuance volume, fueled by increased financing activities from companies with high credit ratings.

Figure 1. Credit bond issuance

<By year>



<Recent trends>

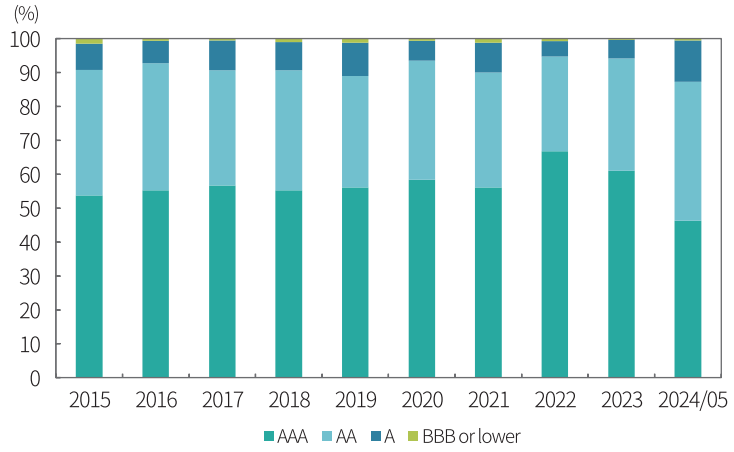


Note: This is based on issuance data, excluding MBS and ABS.
Source: Yonhap Infomax

The majority of publicly offered unsecured credit bonds in Korea are rated A or higher, reflecting conservative investment criteria adopted by investors who consider these bonds eligible investments. The proportion of credit bonds by credit rating is influenced by macroeconomic factors and the supply-demand dynamics in the credit bond market. In 2022, the proportion of AAA-rated bonds surged due to heightened investor sensitivity to credit risk following the Legoland crisis, making it difficult for the market to absorb even AA-rated bonds. More recently, there has been a growing demand for A-rated bonds as investors seek to improve profitability.

The structure of the Korean credit bond market, which predominantly favors blue-chip bonds, imposes constraints on fundraising activities of companies and financial institutions seeking to issue bonds. Companies with lower credit ratings often resort to alternative fundraising methods such as borrowing from financial institutions, private placements, or issuing equity-linked bonds, rather than publicly issuing unsecured bonds.

Figure 2. Proportion of credit bonds by credit rating in Korea



Source: Yonhap Infomax, author's calculation

Maturity structure of credit bonds

Bonds serve as a long-term financing tool for companies and financial institutions. Historically, domestic credit bonds typically had a maturity of around three years, which limited their role as a long-term financing source. However, with the extension of maturities for special bonds and the increase in the issuance of capital securities, the usefulness of credit bonds as a long-term financing tool has improved. Nonetheless, not all issuers are utilizing credit bonds for long-term financing; only companies and financial institutions with high credit ratings have the capacity to issue long-term credit bonds.

An analysis of the maturity structure of credit bonds in Korea reveals a decreasing trend in average maturities in recent years. The average maturity of all credit bonds declined from 4.34 years in 2015 to 3.86 years in 2020, and as of May 2024, the average maturity of credit bonds stood at 2.72 years. This recent shortening in average maturities can be attributed to increased issuance of short-term credit bonds amid rising interest rates. Notably, strategies have been adopted to issue short-term bonds with market expectations for a decrease in interest rates in 2024, while long-term bonds are planned when interest rates fall.

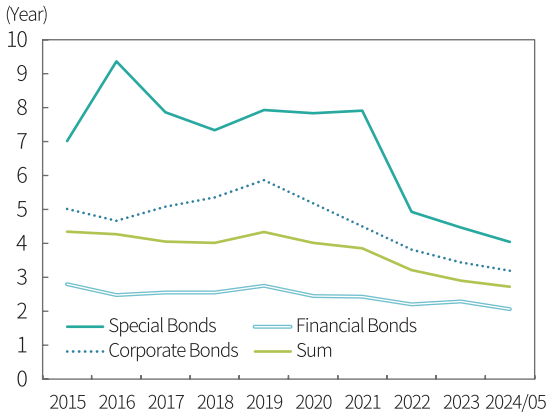
By credit bond type, special bonds typically exhibit a longer average maturity, whereas financial bonds tend to have a shorter average maturity. This variation in average maturities across institutions reflects differing preferences for financing periods. Public corporations often seek long-term financing, resulting in extended average maturities. In contrast, financial

institutions issue publicly-offered unsecured bonds with shorter maturities to adapt flexibly to market conditions, while opting for contingent capital securities for long-term financing purposes.

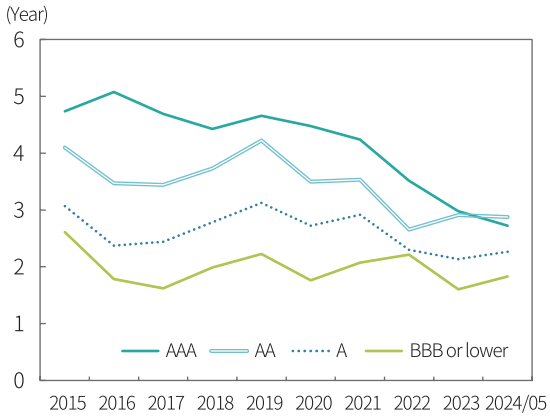
By credit rating, the proportion of long-term credit bonds tends to increase with higher credit ratings. Issuers with high credit ratings have the capacity to absorb long-term credit bonds, thus favoring the issuance of long-term credit bonds in the low interest rate environment. As a result, the average maturity stood at more than four years until 2021. However, recent rate hikes have prompted even high-credit-rated financial institutions to increasingly issue short-term bonds in anticipation of future rate cuts, leading to shorter average maturities.

Figure 3. Average maturity of credit bonds in Korea

<By credit bond type>



<By credit rating>



Note: 1) Based on publicly-offered unsecured bonds
2) Value-weighted average maturities
Source: Yonhap Infomax, author's calculation

Financing cost ratios of credit bonds

In response to global inflationary pressures following the Covid-19 pandemic, central banks worldwide raised policy rates, leading to a surge in most real interest rates by the end of 2022. In 2023, interest rates temporarily declined as market sentiment supported expectations for policy rate cuts. However, persistently high levels of inflation continue to push back rate cuts. Even if rates do fall, it is unlikely that interest rates will return to the low levels observed in the past.

The rise in real interest rates has had a direct impact on the increase in financing cost ratios

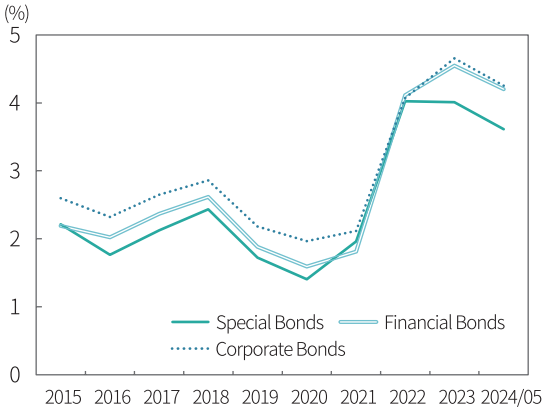
of publicly-offered unsecured credit bonds. The average financing cost ratio for such bonds climbed from 1.89% in 2021 to 4.09% in 2022. Despite a slight decline in bond yields in 2023, the financing cost ratio for publicly-offered unsecured credit bonds rose year-on-year to 4.45%. In 2024, expectations for rate cuts in the second half of the year have led to a decrease in bond issuance rates, with the average financing cost ratio for credit bonds issued through the end of May reaching 4.41%, down from 4.89% of the previous year.

By credit bond type, the financing cost ratios for special bonds declined year-on-year in 2023, while those for financial and corporate bonds posted a year-on-year increase. The recent divergence in average financing cost ratios from bond yield fluctuations can be attributed to the credit quality and issuer composition of credit bonds. Specifically, the weight of relatively lower-rated bonds increased in financial and corporate bonds as investors pursued higher returns and adjusted risk preferences, contributing significantly to the year-on-year rise in average financing cost ratios.

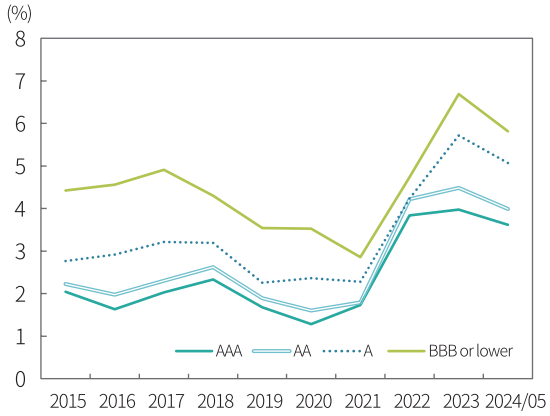
In 2023, the financing cost ratios for AAA- and AA-rated bonds remained similar to the levels of the previous year, whereas the ratios for bonds rated A or lower experienced a year-on-year surge. This result occurred because, during the credit crunch following the Legoland crisis, issuers of A-rated and lower bonds issued them at relatively high yields, especially for refinancing purposes. Meanwhile, financing cost ratios across all ratings have been declining in 2024, and the interest rate difference between credit ratings has also been narrowing.

Figure 4. Financing cost ratios of credit bonds

<By credit bond type>



<By credit rating>



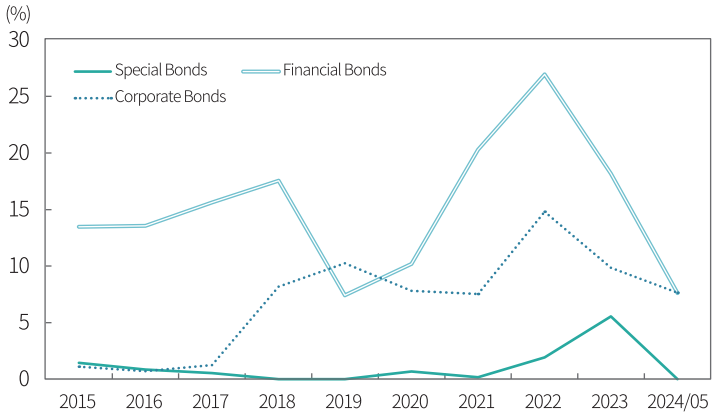
Note: 1) Based on publicly-offered unsecured credit bonds
2) Credit spreads are based on Korea Treasury Bonds with the same maturity.
Source: Yonhap Infomax, author's calculation

Issuing different types of credit bonds

To adapt to evolving market conditions, credit bond issuers are diversifying their bond issuance strategies. With rising interest rates and heightened supply-demand imbalances of credit bonds, some companies and financial institutions have temporarily expanded the issuance of Floating Rate Notes (FRNs) to meet investor demand. An analysis of this trend by period indicates a significant surge in the proportion of FRNs issued in 2022 and 2023, when KEPCO's expansion of bond issuance intensified the supply-demand instability. The increase in FRN issuance during this period reflects the challenges faced by these issuers in absorbing coupon bonds amidst the supply-demand instability. Consequently, companies and financial institutions have scaled up their FRN issuance to better cater to investor demand.

On top of that, there has been a shift in the reference yield structure for FRNs. The majority of newly issued FRNs utilize Constant Maturity Swap (CMS) rates, instead of the conventional 91-day CD rate, as their reference yield. This shift is driven by the CMS rate's ability to quickly reflect market interest rates compared to the CD rate.

Figure 5. Proportion of FRN issuance in credit bonds



Source: Yonhap Infomax, author's calculation

In general, credit bonds serve as a long-term, stable source of financing for companies and financial institutions. Apart from their primary function in capital raising, they are also used to bolster supplementary capital. Issuers of credit bonds typically issue long-term subordinated bonds and Hybrid Tier 1 instruments to raise long-term funds and increase their equity ratios.

Capital securities are primarily issued by financial institutions such as banks, bank holding

companies, insurance companies, securities firms, and credit finance companies. Recently, non-financial companies also tend to issue capital securities to increase their equity capital. In 2023, non-financial companies issued KRW 1.4 trillion worth of capital securities, and as of 2024, KRW 1.4 trillion worth of capital securities have been issued.

Capital securities offer the benefit of improving the capital structure and facilitating relatively long-term financing, despite higher financing costs stemming from their subordinated structure. Therefore, they are widely utilized by companies and financial institutions as a means to enhance corporate financial structures.

Looking ahead

As discussed above, the credit bond market in Korea is experiencing substantial changes in maturity structures, financing cost ratios, and bond structures as the market environment is evolving. In response to rate hikes and a shift in credit supply-demand conditions, domestic credit bond issuers have increased the issuance of short-term bonds, and are endeavoring to improve financing efficiency by diversifying bond structures. Despite these efforts, the upward trend in interest rates driven by inflationary pressures is driving up financing cost ratios for credit bonds, thereby posing challenges for credit bond issuers in the market.

Looking ahead, the conditions surrounding the credit bond market remain challenging. Contrary to market expectations, inflationary pressures are mounting, raising uncertainty about the timing of policy rate cuts. Even if a cycle of rate cuts begins, a return to the previous low interest rate environment is unlikely. The rise in financing cost ratios, led by rising interest rates, poses a potential threat to corporate financial health. In addition, there is a high probability of prolonged PF distress and a slowdown in the construction sector, and some industries may face credit rating downgrades due to sluggish operating performance. Furthermore, the volume of credit bonds maturing this year is expected to increase year-on-year, weighing down on supply and demand conditions.

In the face of these market changes, credit bond issuers should strive to improve profitability, strengthen risk management, and enhance financial stability. They also need to increase the efficiency of financing structures that align with evolving financing conditions. In this respect, it is crucial to establish an efficient financing strategy tailored to specific characteristics of

credit bond issuers, such as business size, creditworthiness, existing funding structures, and refinancing capacity.

Policy efforts are also needed to enhance the stability of the credit bond market. Worsening funding conditions in the market have been primarily driven by external factors rather than the financing structure of issuers. In particular, an external shock, such as the Legoland crisis, drives up financing costs and exacerbates refinancing risks for issuers. Hence, it is necessary to proactively implement policies to mitigate factors that lead to capital market instability. A financial support system should be designed to swiftly address any potential market disruption event. Additionally, policy efforts are needed to enhance the stability of the credit bond market. Specifically, it is crucial to implement policies to reduce inflationary pressures and stabilize interest rates. Lower interest rates can contribute to reducing refinancing costs and burdens for credit bond issuers and ultimately enhance their financial stability.