Korea's Market for Stock Investment Loans and Recent Issues

Lee, Sungbok*

The Korean market for stock investment loans totaled about KRW 15.7 trillion as of 30 June 2018, up 33.3% from nearly KRW 3.9 trillion a year ago thanks to a bull market rally over the past one year. The market growth was driven primarily by margin loans offered by securities companies, and only in part by stock loans extended by third party lenders including mutual savings banks. In these circumstances, there are growing calls for cutting interest rates on stock-based loans. Last June, the Financial Supervisory Service (FSS), the top financial regulator in Korea abolished prepaid fees charged under the name of RMS fees for stock loans. This regulatory action is likely to reduce interest rates on stock investment loans and shorten stock loan tenors. If this comes to pass, the market for stock investment loans could expand at a faster pace due to fiercer competition between securities firms and third party lenders. Taken them together, the financial regulator need to closely monitor the market and take a cautious approach to cutting interest rates on stock investment loans.

Korea saw sharp growth in the market for stock-pledged loans over the past one year, fueled by a strong rally in the stock market. With the market growth, high interest rates called stock-based loans offered to retail customers who want to buy more stocks into question again these days.[1)] Beginning in July 2018, RMS (risk management system) fees are no longer charged to

* 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.

* Ph.D., Research Fellow, Financial Services Industry Department, Tel: 82-2-3771-0657, E-mail: javanfish@kcmi.re.kr

1) Maeil Business News Korea, 15 August 2016, Retail investors are suffering from high interest rates on margin loans; Maeil Business News Korea, 3 April 2017, Be alert to high margin loan interest rates: Yonhap Infomax, 15 July 2018, FSS Head Yoon Seok Heon says the top regulatory watchdog is monitoring high margin loan interest rates.

clients as part of prepared fees for stock loans.[2)] Against the above background, this article discusses the current state and recent issues of the market for stock-pledged lending.

Characteristics of stock investment loans

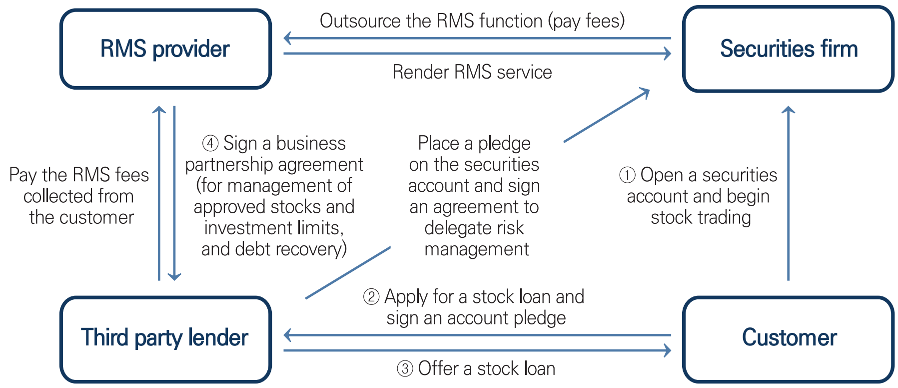
The stock-pledged lending market is not well-known and the structure of stock investment loans is more complex than that of conventional loans. Before exploring the current state of the market, therefore, it would be good to briefly look at stock investment loans. A stock investment loan is a type of loan that is backed by a borrower's shares. Unlike conventional secured loans, the amount a retail client borrows should be used to invest in shares. There are mainly three types of stock investment loans: margin loans backed by stocks, stock-based loans from third party lenders, and Employee Stock Ownership Plan (ESOP) loans. For the sake of discussion, this article only looks into margin loans backed by stocks and stock-based loans from third party lenders (hereinafter referred to as "stock loans").[3)]

Stock investment loans are one type of lending products originally developed by securities companies to meet the funding needs of their customers. Securities companies offer this loan product in the form of a margin loan backed by stocks where the amount borrowed can be used to invest in a limited number of approved stocks, and loan interest rates are generally high and the loan tenor is relatively short. Meantime, third party lenders including mutual savings banks, finance companies and insurance companies offer stock loans where the amount borrowed can be used to invest in a healthy number of approved stocks, and loan interest rates are low and the loan tenure is longer. Stock loans are the loan product developed by risk management system providers in collaboration with mutual savings banks and other finance firms since 2007. Figure 1 depicts the stock loan origination process involving a securities firm, a RMS provider and a third party lender.

2) Financial Supervisory Service (FSS), Press Release (6 June 2018).

3) Stock-based loans from third party lenders are commonly referred to as stock loans.

Figure 1. Stock loan origination process



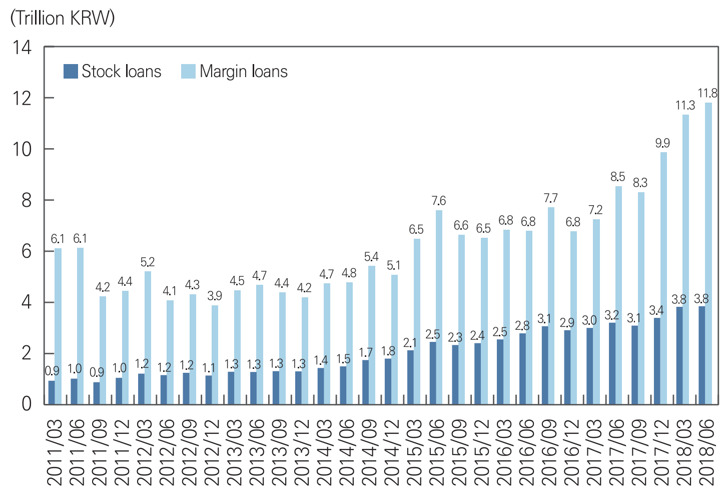
Source: FSS press release (5 June 2018)

Unlike traditional secured loans, both margin loans backed by stocks and stock loans enable lenders to sell all or part of stocks pledged by borrowers before maturity if the value of the collateral falls below the maintenance collateral ratio when stock prices fall. Due to this feature, stock loans are nearly risk-free for lenders, but pose high risks to borrowers by exposing them to market risk. However, margin loans and stock loans differ in many aspects. First, one difference between margin loans and stock loans can be seen when it comes to who is responsible for risk management. With margin loans, securities companies are responsible for managing risks associated with the loans. With stock loans, RMS providers are responsible for risk management. Second, calculating a customer's borrowing limit, i.e., the maximum amount that the loan makes available is complex for margin loans but simple for stock loans. The maximum amount available for a margin loan is determined by the market value of stocks that a client holds, margin ratio, and cash collateral ratio. Generally, the required margin ratio ranges from 45 % to 60% according to types of brokerage accounts used for margin lending. On the other hand, the maximum loan amount for a stock loan depends on the value of securities pledged as collateral at the time of the loan application. In accordance with the Standard Working Rules for Risk Management of Financial Investment Companies published by Korea Financial Investment Association (KOFIA), if the collateral value surpasses KRW 100 million, the maximum loan limit is 200% of the collateral value. If the collateral value is between KRW 50 million and KRW 100 million, the maximum loan limit is 250% of the collateral value. If the collateral value is KRW 50 million or less, the maximum loan limit is 300% of the collateral value. Third, a customer can borrow up to KRW 3 billion with a margin loan using his or her margin account at once if margin requirements are met, though maximum loan limits vary slightly from one securities firm to another. In contrast, a customer can borrow up to KRW 300 million with a stock loan using his or her brokerage account regardless of the collateral value. Fourth, margin loans and stock loans are different in terms of a loan tenor. The term of a margin loan is no more than three months or less than six months. The term of a stock loan is at least three months, or six months or longer and can be extended up to five years. Generally, the average tenor of margin loans is less than one month while the average tenor of stock loans is more than six months. Meantime, it is known that stock investment loans have no maturity date. Customers can pay off the loans any time without paying prepayment penalty. Fifth, lenders charged prepaid fees called RMS fees for stock loans. As the FSS unveiled a "measure to improve the practice of charging prepaid fees on stock loans" on 5 June 2018, RMS fees were abolished in July 2018, being internalized in interest rates on stock loans. Previously, borrowers must pre-pay 2% of the loan amount as RMS fees to RMS providers. RMS fees were exempted if the term of an existing stock loan was extended.

Current state of the market for stock investment loans

The market for stock investment loans stood at KRW 15.7 trillion in loans outstanding as of 30 June 2018, up 33.3% from KRW 3.9 trillion a year ago. The market growth is attributable primarily to a sharp pickup in the stock market since the second half of 2017. When dividing the lending market into margin loan and stock loan segments, margin loans outstanding amounted to KRW 11.8 trillion as of 30 June 2018, up 27.7% from KRW 3.3 trillion a year earlier, and stock loans outstanding were approximately KRW 3.8 trillion, up 16.7% from KRW 0.6 trillion a year ago. As of 30 June 2018, margin loans accounted for about 75.5% of the market for stock investment loans, a 2.7% year-over-year increase, while stock loans represented nearly 24.5%. This suggests that the increase in margin loans contributed significantly to the recent growth in the loan market. Meanwhile, due to the high share of margin loans in the market, the magnitude of fluctuations in margin loans appears to be greater than that in stock loans.

Figure 2. Quarterly outstanding volumes of margin loans and stock loans



Source: KOFIA, RMS Association

There are two reasons behind the higher proportion of margin loans in the market for stock investment loans than that of stock loans. First, short-term financing needs are higher than long-term financing needs with regard to stock investment loans. This is evident when comparing interest rates for margin loans and stock loans. Margin loan interest rates published on KOFIA's website as of 15 July 2018 averaged 6.6 % to 9.3%. The longer the loan term, the higher the average interest rate is.

Table 1. Average margin loan interest rates

(Unit: %)

Loan term	1~15 days	16~30 days	31~60 days	61~90 days	91~120 days	121~150 days	151~180 days	More than 180 days
Average interest rate	6.6	7.3	8.1	8.6	9.3	9.3	9.2	9.3

Note: Simple average of interest rates on margin loans offered by 33 securities firms by the loan tenor
Source: KOFIA website (as of 15 July 2018)

Overall, average stock loan interest rates were lower than average margin loan interest rates, considering the difference in the loan term. It is noteworthy that the average stock loan interest rate, following the internalization of RMS fees in the interest rate, appears to be higher than the average margin loan interest rate when the loan term is less than 15 days. As a result of the inclusion of RMS fees in the stock loan interest rate, the average interest rates ranged from 6.64%

to 7.13% as of 15 July 2018, which are lower than before for stock loans whose term is one year or shorter, and higher for stock loans whose term is more than one year. Contrary to margin loans, the longer the loan term, the lower the average interest rate is.

The comparison of the average interest rates of margin loans and stock loans found that customers in need of short-term financing have more incentives to use margin loans while customers in need of long-term funding have more incentives to use stock loans, when it comes to loan interest rates. Securities firms strategically provide loans targeting clients with higher short-term funding needs to invest in shares while third party lenders such as mutual savings banks target clients with higher long-term funding needs, differentiating their loan products from margin loans offered by securities companies.

Table 2. Average stock loan interest rates

(Unit: %)

		3 months	6 months	12 months	24 months	36 months
Before June-end, 2018[1]	Average interest rate	3.62	4.41	5.08	4.71	4.21
	Average fees	1.98	1.86	1.33	2.86	2.12
	Real average interest rate[3]	11.54	8.13	6.41	6.14	4.92
After June-end, 2018[2]	Average interest rate	7.13	6.85	6.64	-[4]	-[4]

Note: 1) Simple average of interest rates and RMS fees by the loan term on 2,122 stock loans whose maturity dates were posted on the websites of S&C (including Hi Stock Loans) and FoxNet as of 31 May 2018

2) Simple average of interest rates on 162 stock loans by the loan term, provided through NH Investment & Securities, Hana Financial Investment, Kiwoom Securities and KB Securities & Investment by Hi Stock Loan and FoxNet as of 15 July 2018

3) Real average interest rates are the sum of the average interest rates and annualized average RMS fees (without considering the extension of the loan term; if the term of a loan is extended to six more months, RMS fees are exempted and the loan interest rate is up by about 2%p).

4) After the internalization of RMS fees in the interest rate of a stock loan, interest rates for stock loans whose term is 12 months or longer were not published via the website or other sources as of 15 July 2018.

Second, if customers have stronger demand for a short-term loan to invest in shares, they tend to prefer easily accessible margin loans. It is a hassle to apply for a stock loan because of the loan origination process involving a securities company, a RMS provider, and a third party lender such as a mutual savings bank. Also, stock loans could be an inconvenient financing tool for customers because they have to trade stocks using multiple accounts if they want to borrow more than the maximum stock loan limit of KRW 300 million. Not only that, there were around 8,000 stock loan products as of 30 May 2018 with competitive marketing of RMS providers.

Although this means a wide array of choices for customers, stock loans with similar terms and conditions could increase search costs incurred by customers.

The growth in the market for stock investment loans has been losing momentum slightly as the stock market has continued to fluctuate in the midst of recent trade disputes. Margin loans exceeded KRW 12 trillion in April and May and turned downward again. Stock loans turned to decline as well due to the abolition of RMS fees.[4)] Nevertheless, the market for stock investment loans could grow constantly given the stock market volatility and the impact of institutional changes that will be discussed below.

Current issues surrounding stock investment loans

The rapid market growth over the last year raised new issues about high interest rates on stock investment loans and the collection of prepaid RMS fees. High loan interest rates came under fire again because stock investment loans are almost risk-free for securities companies and third party lenders. Before simply criticizing the high interest rates, it is necessary to better understand the nature of loan interest rates. Interest rates on stock investment loans reflect the cost of raising funds and the opportunity cost of the funds. Securities firms raise funds for margin loans from Korea Securities Finance (KSF) and by issuing electronic short-term bonds (ESBT). As of 31 December 2017, KSF and ESBT (one-day, rated 'A1') borrowing rates were 1.45% to 1.90%, and 1.87%, respectively. Moreover, securities companies may earn high returns when using the funds to invest directly in stocks. Such opportunity cost is reflected in the interest rate of a margin loan. It is also true for third party lenders. For mutual savings banks, one-year term deposit rate was 2.4% as of 31 December 2017. Given that the average maturity of term deposits is less than one year, the average cost of capital would be less than 2.0%. Installment financing firms raise funds by issuing bonds and commercial paper (CP). As of 31 December 2017, interest rates on one-day 'A1' CP and two-year 'AA-' bonds issued by installment financing companies were around 1.5% and nearly 2.4%, respectively. Moreover, mutual savings banks and installment financing firms would use the funds to provide credit loans or secured loans at interest rates of 4% to 6% for customers with high credit quality. The opportunity cost is also reflected in the interest rate of a stock loan. In addition, relatively high interest rates on

4) The decline in stock loans was attributed to the temporary suspension of stock loan origination by some mutual savings banks to eliminate RMS fees and include them in loan interest rates.

stock investment loans are due to a kind of credit allocation tool embedded in the products. As interest rates go down, more and more customers can get stock investment loans at lower costs. However, this could leave financial consumers more exposed to the risk of their securities being liquidated as a result of stock price movements, and suffer from large losses due to liquidation in the event of short-term stock market fluctuations. Taken them together, it may not necessarily be desirable to lower interest rates on stock investment loans so as to provide financial consumers with opportunities to borrow money at lower costs to invest in stocks.

Furthermore, the financial regulator prohibited financial firms from charging customers prepaid RMS fees on a stock loan, beginning from July 2018 for the following two reasons. First, charging RMS fees runs counter to the benefit principle. RMS providers manage risks associated with the securities pledged as collateral by customers for stock loans on behalf of third party lenders. RMS providers designate stocks not eligible for investment depending on market conditions, assess the maintenance rate of customer accounts, and send a notice of additional collateral requirements to customers or liquidate the securities when the maintenance rate falls below a certain threshold. Therefore, it is deemed reasonable that RMS fees should be borne by third party lenders, not customers. Also, charging RMS fees separately could mislead customers to believe that stock loan interest rates are lower than margin loan interest rates. For instance, if a stock loan, like a margin loan, has a term of less than one month, its actual interest rate could be higher than a margin loan with the same term when RMS fees are annualized and incorporated into the interest rate. However, the financial authority's stance can be understood differently in two aspects. First, customers would also benefit from risk management services offered by RMS providers because they can preemptively manage the liquidation risk through risk management by RMS providers. Besides, stock loans whose term is one month or longer surpassed 85% of total stock loans, meaning that it would be unreasonable to compare the interest rates of stock loans and margin loans, both of which have a term of less than one month. RMS fees continued to decline owing to competition among RMS providers. Going forward, the fees will be determined through negotiation between RMS providers and third party lenders, and then will be reflected in stock loan interest rates. Thus, the fees competition among RMS providers is likely to weaken. More importantly, the abolition of prepaid fees charged under the name of RMS fees brings down interest rates on stock loans whose term is less than one year but pushes up those whose term is more than one year. Consequently, stock loans are likely to have shorter terms.

Conclusion

On the part of customers, stock investment loans enable them to increase investment returns but cause significant losses from stock price movements. By contrast, on the part of securities companies and third party lenders including mutual savings banks, stock investment loans are risk-free products enabling nearly full debt recovery through the liquidation of shares pledged as collateral. For that reason, the market for stock investment loans could grow rapidly during stock market rallies, whereas producing various side effects when the stock market tumbles, triggering the liquidation of pledged shares. Accordingly, not only the financial regulator but also securities companies and third party lenders should closely monitor the market for stock investment loans. Specifically, competition among securities firms and third party lenders would occur to attract customers in need of short-term financing if the tenors of stock loans get shorter than before owing to the removal of RMS fees. Furthermore, the lending market is likely to grow at a faster pace if such competition leads to lower interest rates. Given that, the financial regulator needs to take a cautious approach to cutting interest rates on stock investment loans.