

Margin Trading in Korea's Stock Market and Direction for its Improvement

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Margin trading in the Korean stock market has continuously developed, mainly led by margin trading long. Margin trading long and short are symmetric, like the two sides of a coin. In spite of their similar purposes and economic functions, margin trading long and short differ greatly in the degree of utilization. Margin trading long is very actively being used by individual investors whereas margin trading short is rarely being used.

To promote balanced development in margin trading, it is worth noting the need to broaden the scope of eligible stocks for margin trading short. When individual investors use margin trading short, the biggest obstacle is the lack of eligible stocks in the scope and the quantity. Securities firms can take on an important role, but this would not be enough under current stock market conditions. By making use of Japan's case as a good guide, Korea should consider diverse measures such as creating a centralized body for the provision of margin trading short service to achieve the economies of scale, and increasing the use of collateral pledged for loans to obtain sources of lending for margin trading short. In addition, the way credit risk associated with margin trading short is managed should be improved efficiently. What is important in credit risk management is that the use of margin trading short should not be too difficult, though the excessive use of leverage needs to be curbed. It is worth considering designing progressive margin ratios and, if needed, requiring part of margin to be paid on a cash-only basis to ensure adequate management of credit risk in the market.

* 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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Margin trading in the Korean stock market is considered as one of the popular investing strategies often used by individual investors. Margin trading means trading stocks on margin (credit) that securities firms provide to their customers (individual investors) in accordance with the Financial Investment Services and Capital Markets Act (FSCMA).¹⁾ More specifically, it refers to the process whereby an investor borrows money from his or her securities firm to buy stocks or borrow stocks and then sell those stocks by paying an initial margin pre-determined by the securities firm.²⁾ The act of borrowing money to buy stocks is called margin trading long while the act of borrowing securities to sell the borrowed securities is called margin trading short. The securities firm, which provides margin trading service, collects margins from its clients, settles stock trades for the clients by lending funds or securities to them, and accepts the securities purchased or proceeds from the sale of securities as collateral for risk management. Margin trading can be divided into two types according to the source of funds or securities: the one for which securities companies use their own funds or securities as the source of financing, and the other which securities firms borrow funds or securities from a securities finance company. The latter type is the lending service an investment dealer or broker provides to its customers for the trade of stocks, using funds or securities borrowed from Korea Securities Finance Corporation (KSFC) through the clearing system in the Korea Exchange.³⁾

In the Korean stock market, margin trading has developed around margin trading long over a long period of time. Although margin trading allows investors to be symmetric, reacting equally to ups and downs of the stock market, it has been used only to move in one direction. This can be understood as the limits of the domestic stock market. For margin trading to develop further in a balanced manner, current institutional arrangements should be improved. This article examines the current state of margin trading in Korea, and explores ways to revamp institutional arrangements for margin trading in order to make the stock market more efficient and liquid.

Current state of margin trading in the Korean stock market

Margin trading long positions as of June 30, 2018 totaled KRW 11.8 trillion, KRW 6.0 trillion and KRW 5.8 trillion of which came from the KOSPI market and the KOSDAQ market, respectively.

1) Article 72.1 (Credit Grant) of the FSCMA

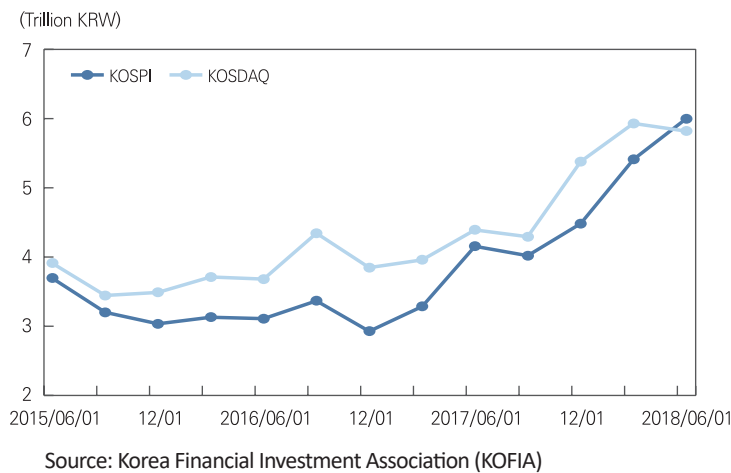
2) Article 69.1.1. (Credit Grant) of the Enforcement Decree of the FSCMA

3) See Business Rules for Korea Securities Finance Corporation (KSFC).



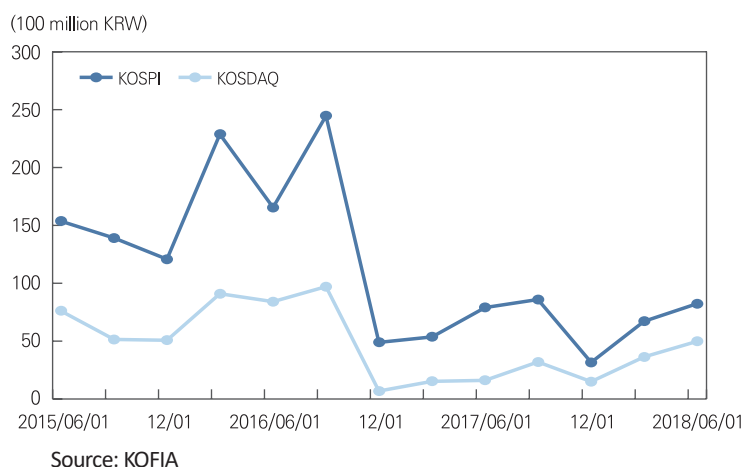
Margin trading long positions in the KOSPI were slightly above those in the KOSDAQ. Margin trading long has been more actively used in the KOSPI than the KOSDAQ over a prolonged period of time. Take an example of the first quarter of 2010. Margin trading long positions in the KOSPI market stood at KRW 3.0 trillion, two times higher than that KRW 1.5 trillion in the KOSDAQ market. However, the balance of margin trading long in the KOSDAQ market grew rapidly, overtaking that in the KOSPI market for the first time in the first half of 2015, and staying above the KOSPI level thereafter. However, it is observed that the KOSPI market overtook the KOSDAQ market in the balance of margin trading long in June 2018.

Figure 1. Trends in margin trading long balance



Margin trading short positions as of June 30, 2018 were just KRW 13.2 billion. Despite the fact that margin trading long and short are symmetric, there exists an incomparably huge gap between long and short positions. Margin trading short positions exceeded KRW 53 billion, hitting its record high in the second quarter of 2012, but decreased gradually to KRW 34 billion in September 2016. As KSFC’s securities lending discontinued in November 2016, margin trading short positions plummeted to KRW 5.7 billion in December 2016. The balance of margin trading short in the KOSPI and KOSDAQ markets as of June 30, 2018 amounted to KRW 8.3 billion and KRW 4.9 billion, respectively. In contrast to the balance of margin trading long in which the KOSDAQ market surpassed the KOSPI market, margin trading short positions in the KOSDAQ have never exceeded those in the KOSPI on a quarterly basis.

Figure 2. Trends in margin trading short balance



Margin trading short and short-selling by individual investors

Margin trading long and short are designed to be symmetric, like the two sides of a coin. In February 1969, margin trading long was introduced together with margin trading short, to balance supply and demand in the stock market.⁴⁾ Except that margin trading long and short work in the opposite direction over stock prices, these two are structurally the same in the sense that investors who do not own money or securities seek for gaining opportunities in anticipation of rising or falling stock prices. Also, margin trading long and short serve the same economic function, providing liquidity in the stock market. Margin trading long plays a role in increasing liquidity in a bull market. Margin trading short enhances market liquidity in a bear market. Moreover, both of margin trading long and short help make price discovery more efficient. In spite of their similar purposes and economic functions, margin trading long and short differ greatly in the degree of utilization. Margin trading long is very actively being used by individual investors whereas margin trading short is rarely being used. As described above, long and short margin trading positions amounted to KRW 11.8 trillion and KRW 13.2 billion as of June 30, 2018, respectively. The volume of margin trading long is approximately 900 times that of margin trading short. Given that margin trading service caters to individual investors, the use of margin trading long by investors is very active, while the use of margin trading short is extremely low. To facilitate the balanced growth of the market, it is crucial to find ways to address problems with margin trading short.

4) Joonseok Kim and Kibum Bin, 2009, A study on stock short-sale: A review of recent issues and policy implications, KCFI.



In practice, margin trading short is the only short-selling strategy that individual investors can employ. In Korea, naked short sale is prohibited under the FSCMA. To undertake a short sale transaction, individual investors must first borrow shares but encounter considerable difficulties doing so directly because their credit level is much weaker than institutional investors'. As such, there is almost no institution for individual investors to borrow shares, greatly limiting the participation of individuals in short selling as a consequence. Except for some super rich individuals called "super ants" in Korea, individual investors can borrow stocks only through margin trading short service offered by securities firms. However, margin trading-eligible stocks are available only for a limited number of companies and in limited quantity, which make it daunting for investors to borrow in real time the stocks they pick as much as they need. If borrowing stocks is difficult, short selling can hardly be a regular strategy accessible to individual investors.

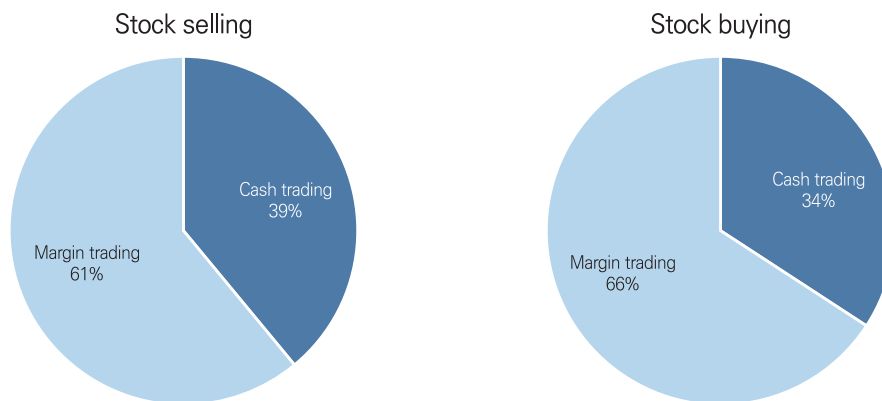
The reason why only the limited quantity of stocks are eligible for margin trading short is that the stocks pledged as collateral for margin trading long can only be used as a source of funding for margin trading short. Even in such a case, explicit consent from the users of margin trading long service is required. Without the explicit consent, collateral shares cannot be used as a source of financing for margin trading short. For that reason, eligible stocks are inevitably limited in terms of scope and quantity. In order to lower the high barriers to entry for individual investors with respect to margin trading short, it is important to create the market environment where individual investors are able to borrow a variety of stocks in the desired quantity.

Margin trading in the Japanese stock market

It can be very useful to make reference to margin trading in Japan's stock market when seeking ways to improve margin trading in the domestic stock market. The proportion of individual investors in the Japanese stock market is higher than in the US or European market, and both long and short margin trades by individual investors are active. Japanese individual investors trade stocks on margin more than cash. Their margin trading is 1.5 or 2 times more vibrant than their cash trading. In 2017, the individual investors sold JPY 103.6 trillion worth of shares, 61.0% of which were margin trades totaling JPY 63.2 trillion, and only 39.0% were cash trades totaling JPY 40.4 trillion. During the same period, the investors bought JPY 97.7 trillion worth of shares, 65.8% of which were margin trades totaling JPY 64.3 trillion, and 34.5% were cash trades totaling JPY 33.4 trillion. Japanese individual investors' reliance on margin trading

showed a similar pattern in the first half of 2018. Margin trades represented 63.7% of stock sales and 64.8% of stock purchases by individual investors in the first half of 2018.

Figure 3. Characteristics of individual investors' trading pattern in Japan (as measured by trading value in 2017)



Source: Japan Exchange (JPX)

The heavy dependence on margin trading of Japanese individual investors stands in stark contrast to the trading behavior of Korean individual investors. For domestic individual investors, margin trading accounts for only a small portion of stock purchases, and also make up a much lower portion of stock sales in Korea than those in Japan. The well-established infrastructure for margin trading is one of the reasons why margin trades take up the large proportion of total stock trades by individual investors in Japan. In the Japanese stock market, securities companies and other securities-related institutions provide services for individual investors to buy and sell stocks on margin. These services are considered to be specific and extensive, so individual investors can often easily use the investment strategy.

Improving margin trading in the Korean stock market

The Korean stock market is highly likely to see steady growth in margin trading, underpinned primarily by margin trading long. However, despite the increase in margin trading, if the current phenomenon continues, market inefficiency and complaints about margin trading short from individual investors would not decline. Hence, it is necessary to find ways to expand margin trading short service, given that the credit level of individual investors is lower than that of institutional investors.



Alleviating the extreme asymmetry between margin trading long and short would be meaningful in that it could help the stock market achieve balance in the efficiency of stock prices in both directions. Margin trading long for investing in the hope of higher stock prices is being utilized as an important market strategy by individual investors, and it has positive impacts on market liquidity and efficiency gains. However, margin trading short, which is economically symmetric with margin trading long, is not actively being used by individuals. Therefore, positive effects from margin trading short are hardly expected. Improving institutional arrangements for balanced margin trading activities would be critical to ensure stock market development in the long run.

To promote balanced development in margin trading, it is worth noting the need to broaden the scope of eligible stocks for margin trading short. When individual investors use margin trading short, the biggest obstacle is the lack of eligible stocks in the scope and the quantity. Securities firms can take on an important role, but this would not be enough under current stock market conditions. By making use of Japan's case as a good guide, Korea should consider diverse measures such as creating a centralized body for the provision of margin trading short service to achieve the economies of scale, and increasing the use of collateral pledged for loans to obtain sources of funding for margin trading short. In addition, the way credit risk associated with margin trading short is managed should be improved efficiently. What is important in credit risk management is that the use of margin trading short should not be too difficult, though the excessive use of leverage needs to be curbed. It is worth considering designing progressive margin ratios and, if needed, requiring part of margin to be paid on a cash-only basis to ensure adequate management of credit risk in the market.