

LAUNCHING OF THE STOCK INDEX FUTURES MARKET IN KOREA

A New Frontier in the Financial Market

In a recent article in Fortune magazine, two out of three global investing superstars cited Korea as one of the most attractive emerging markets in Asia for the year. Their rosy forecast is probably stems from the faster and wider liberalization and deregulation of the Korean capital market and Korea's possible entry into the Organization for Economic Cooperation and Development (OECD) late this year. Foreign investors realize that the ongoing deregulation and liberalization of the local capital market will most likely create more favorable conditions for them. At the same time, they also remain aware of the negative impact the slush fund scandal involving two former presidents has on investor sentiments and the possible build-up of inflationary pressure and labor problems because of the forthcoming parliamentary general elections in April. For foreign investors seeking rational investment abroad, the Korean stock index futures market will broaden investor options in Korea and can be used as a risk hedging tool. Ultimately, the futures market will greatly contribute to the globalization of the Korean stock market.

The preparations for the KOSPI 200 Futures Market opening have been consistently underway for a considerable amount of time, and the stock index futures market will open on the Korean Stock Exchange (KSE) from May 3, 1996. The Futures Contract Act was passed by the National Assembly on November 30, 1995, and comes into effect on July 1, 1996. Therefore, the Korean Futures Exchange could be in operation by sometime in 1996.

The Mechanism of KOSPI 200 Futures Contracts

The index underlying futures contracts will be the KOSPI 200, a composite price index of the stocks of 200 large companies listed on the Korean Stock Exchange (KSE). The base date is January 3, 1990, for which the value of the KOSPI 200 is 100. Contracts months, or delivery months, come quarterly, with contracts coming due in March, June, September, and December. The last trading day for each contract month will be the second Thursday of the month. The equity index market will close 15 minutes later than the spot stock market but 10 minutes earlier on the last trading days.

To open accounts, buyers and sellers will have to put an initial margin requirement of 30 million won and more with their futures commission merchants, while a 10 percent maintenance margin is the minimum amount per contract that a customer must keep on deposit at all the time. Traders of contracts will be required to put up a margin fund equivalent to 15 percent of the contract size with futures commission merchants.

The equity index future will be settled in cash two days after the last trading day of each contract month. The stock index futures price will be the same as the cash (spot) stock index, or KOSPI 200, times 500,000 won, and the minimum quotation unit or minimum price fluctuation band will be the 0.05 index point, or 25,000 won. The daily price fluctuation band will be plus or minus 5 percent.

Successful trading of the index contracts requires a through understanding of the construction of the index. As is the case with all futures contracts, the exact construction of the contracts is very important for the trader. No-arbitrage condi-

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tions constrain possible deviations between the price of the futures contract and the level of the underlying index. Cash-and-carry strategies keep the futures price being too high relative to the price of the stock market index. Similarly, the availability of reverse cash-and-carry strategies keep the futures price from being too low relative to stock prices. In other words, potential arbitrage strategies constrain the basis for stock index futures just as they do for other types of futures contracts.

In order to become a futures commission merchant, domestic and joint-venture securities firms need to be capitalized at more than 50 billion won. In the case of foreign brokerage houses, only foreign branches with a minimum operating capital of 15 billion won and with licenses for general business will qualify. Under these conditions, two domestic securities houses—Keonseol and Shin-Heung—do not qualify, while six foreign securities houses—Jardine Fleming, Citicorp, Scrimgeour Vickers, Bankers' Trust International, Daiwa and Nomura—currently meet these demands. The other foreign securities houses will increase their operating capital and meet the minimum requirement to become futures commission merchants. A full-fledged mock operation of the market will be conducted between February and April.

The Role of Stock Index Futures

Everyone who follows financial news hears predictions about the future of the stock market. Usually these predictions refer to the futures price movement of some stock market index.

With the advent of stock index futures trading in 1982, these pundits can now trade to take advantage of their insights. In addition to providing a chance to speculate, stock index futures also have a role in hedging various kinds of portfolio

risk. Currently, dramatic changes in stock index futures are taking place. Previously successful contracts are greatly diminishing in importance, while other new contracts are beginning to gain ascendancy.

Speculating with stock index futures is exciting. Futures contracts allow the speculator to both make the most straightforward speculation on the direction of the market or enter very sophisticated spread transactions to tailor their futures position to more precise opinions about the direction of stock prices. Further, the low transactions costs in the futures market make speculation much easier to undertake than similar speculation in the stock market itself. One of the simplest speculative positions arises from a belief about impending market movements. If a trader anticipates a major market rally, he could simply buy a futures contract and hope for a price rise in the futures contract when the reality actually occurs. While this course of action is simple, it does not do full justice to the complexity of the speculative opportunity. The trader might also consider which contract maturity is desirable as a trading vehicle.

Hedging with stock index futures applies directly to the management of stock portfolios. A hedge's basic definition is a position in "futures" opposite to the position one has assumed in "actuals" (the cash market). It is a kind of offset transaction which reduces, or under ideal circumstances, eliminates speculative price risks. The usefulness of stock index futures in portfolio management stems from the fact that they directly represent the market portfolio. Before stock index futures began to be traded, there was no comparable way of trading an instrument that gave the price performance so directly tied to a broad market index. Further, stock index futures have great potential in portfolio management due to their very low transaction costs. A portfolio manager could protect against a potential bear market (which is represented by decreasing market prices) by doing a short hedge (selling futures and buying underly-

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ing assets). By the same method, trader could capitalize on a potential bull market by using futures as a substitute for actually buying shares.

The Voice of Worry

The launching of the index market will require effective government supervision in order to prevent unfair trading or accidents. While this requirement may be somewhat hard to meet in the Korean financial market, the absence of strong management and supervision could result in a market failure.

Also, regulations on the underlying stock market should be eased or eliminated. In particular, short sales should be available for all stocks. Trading of stock index futures, which is essentially based on rational predictions, will be in the doldrums if the government continues to intervene in the market. The existence of the Stock Market Stabilization Fund leaves much room for such worries.

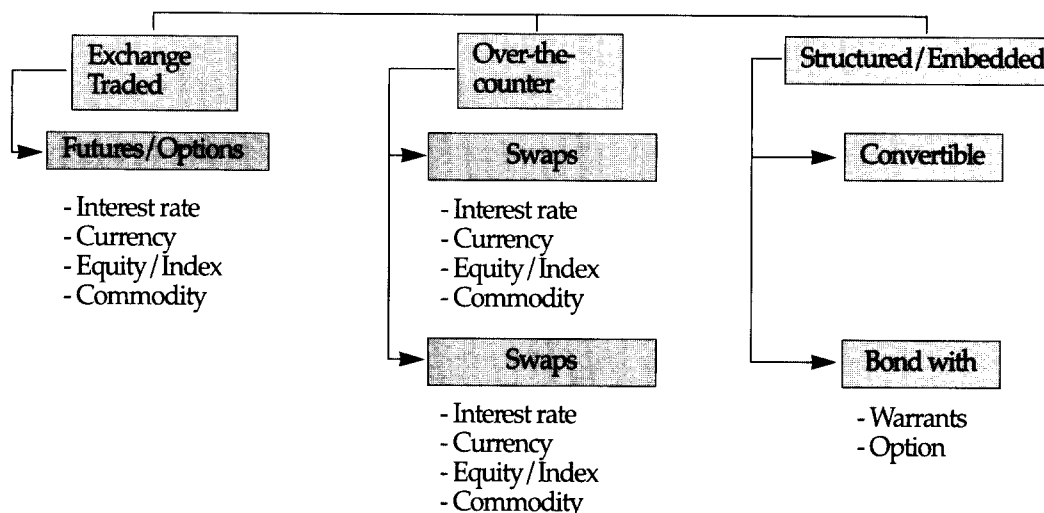
Since the derivative markets and cash markets

are different in purpose, they have different needs and require different management. This is particularly true during the start-up of a new derivative exchange, because all too often a stock exchange is overly cautious about the effect derivatives may have on the stock market, dampening activity in derivatives. This over-caution by stock exchanges is, however, entirely misplaced since significant academic study has shown that stock derivatives stimulate stock trading by bringing new players and users into the market who are more willing to invest in stocks because they can now hedge their positions. These new participants bring a new source of order flow to the stock exchange, and bring a new source of market information about longer term trends. The problem is, wherever derivative markets throughout the world have been established and run by stock exchanges they have usually failed. For the time being, the KOSPI 200 futures will be traded on the Korean Stock Exchange. Ultimately, however, the Korean Futures Exchange which is going to be built will be the ideal place for such trading. ^{VIP}

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The Financial Derivative World



Source : *Complex Derivatives*, Eric Banks, 1994