The National Association of Financial Market Institutional Investors published new guidelines last year that pave the way for the launch of a credit derivatives market in China. What are the hurdles to growth? By ***Benjamin Liu****,* ***Chin-Chong Liew****,* ***Simon Zhang*** *and* ***Chris Zhao***

China gets credit

After months of anticipation, the National Association of Financial Market Institutional Investors (Nafmii) published the *Guidelines for interbank market credit risk mitigation instruments (pilot scheme)* on October 29, 2010. This is a major milestone in the China interbank market and paves the way for the launch of an onshore credit derivatives market.

The instruments introduced under the pilot scheme are relatively simple. At this stage, only two types of products are allowed: credit risk mitigation (CRM) contracts, which are effectively over-the-counter single-name reference obligation-only credit default swaps (CDSs); and CRM warrants, which are transferrable instruments giving holders the right to put reference obligations to the issuer.

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What are CRM contracts and CRM warrants?

These are dubbed credit risk mitigation instruments in the guidelines – the term was carefully chosen to disassociate them from the negative connotations surrounding CDSs in the international markets. The guidelines also state CRM instruments include other simple and basic credit risk management products. But while leaving room for other types of structures to be introduced later, only CRM contracts and CRM warrants are contemplated at this stage.

CRM contracts

A CRM contract is an agreement under which the credit protection buyer pays a premium to the seller, and the seller provides credit risk protection on a reference obligation. Although not expressly stated, it would seem that settlement of a CRM contract (whether by cash settlement, physical delivery or auction settlement) has to be conducted in connection with the reference obligation.

The guidelines define reference obligations as "bonds or other similar debts" of the reference entity. This term would include financial bonds, as well as corporate bonds and debt financing instruments (which are traded on the interbank bond market) issued by companies. Structured bonds such as asset-backed securities (ABSs) traded in the interbank market can technically qualify as reference obligations, but it is unlikely they will be used as reference obligations on any CRM contract, as CRM instruments are meant to be "simple and basic" risk management products. Accordingly, CDSs on ABSs will be out of bounds for the moment.

Although not expressly stated, it seems clear loans would fall within the ambit of "other similar debts" and would qualify as a reference obligation. However, it is doubtful if other types of payment obligations, such as trade receivables and swap obligations, could qualify as reference obligations.

Given the requirement of credit linkage to a reference obligation, CRM contracts are akin to 'Ref Ob Only' CDSs traded in the international markets. However, it is uncertain whether other permutations will be acceptable to Nafmii and the interbank markets. Would parties be able to conduct CRM contracts on reference obligations on a portfolio basis? Would it be acceptable to use other debt obligations, rather than the specified reference obligation, to settle a CRM contract? Would nth-to-default credit derivatives products be allowed? At this stage, the answers to these questions would appear to be no, as only simple and basic products are allowed under the guidelines.

Meanwhile, there is no mandatory central clearing requirement for CRM contracts. This is understandable given the credit derivatives market in China is in its infancy, and it remains to be seen whether there is any need for central clearing. It is also uncertain whether the terms of CRM contracts will be standardised, which is a prerequisite for central clearing.

CRM warrants

A CRM warrant is akin to a credit-linked put warrant. Upon the occurrence of a credit event, holders of CRM warrants are entitled to put (or deliver) the reference obligations to the issuer against payment by the issuer of the relevant notional amounts.

Credit-linked put warrants are rare even in the international markets, so it may come as a surprise that such a product is being introduced in China at this very early stage of development. One possible explanation is that Chinese banks are currently not allowed to provide guarantees for corporate debt. Therefore, CRM warrants provide an alternative route through which banks can sell credit protection. This protection can be transferred to third parties, together with the relevant reference obligations, subsequent to issuance.

An issuer of CRM warrants has to be either a primary dealer or a dealer that satisfies certain requirements and is approved by Nafmii. Similar to corporate bonds issued in the interbank market, issuance of CRM warrants is subject to the approval of an expert panel to be set up by Nafmii. In terms of the scope of review by the expert panel, the guidelines declare the group will not make any substantive assessment in terms of the investment value or risk of the CRM warrants under review. The guidelines do not expressly state the basis on which the expert panel will decide whether to accept or reject an application.

Who can trade CRM instruments?

The guidelines build up a tiered market access qualification system for CRM instruments and divide interbank market participants into three categories: dealers, primary dealers and non-dealers.

■ **Dealers.** A dealer can trade CRM instruments with other dealers or primary dealers, but not with non-dealers. In addition, the guidelines require a dealer to trade CRM instruments "for its own needs". This raises an interesting question as to the precise scope of this restriction. Given that non-dealers can only trade CRM instruments "for hedging purposes", it would appear that the term "for its own needs" should be broader than, and not limited to, hedging. Accordingly, it would seem reasonable to conclude that transactions carried out by a dealer for hedging purposes or for profit would be considered "for its own needs", whereas trades on behalf of clients or on an agency basis by a dealer may not.

To become a dealer, the relevant market participant must meet certain requirements, such as having a registered capital or net equity of not less than 800 million renminbi ($120.2 million), having not less than three staff members with relevant experience and qualifications, and the requisite internal capability to conduct valuations and risk assessment.

An applicant should file materials to Nafmii's secretariat office to demonstrate it satisfies the qualification criteria, and will become a dealer upon such filing being made.

■ **Primary dealers.** A primary dealer can trade CRM instruments with all market participants and is not subject to any hedging or own needs requirements.

Only a dealer can apply to become a primary dealer. To qualify as a primary dealer, the firm should have a registered capital or net equity of not less than 4 billion renminbi, be a market maker on either the interbank bond market or the interbank foreign exchange market, and have a minimum two-year track record in conducting a financial derivatives business.

An applicant must submit documentary proof and application materials to Nafmii's secretariat office. The Nafmii financial derivatives professional committee will then review the application to decide whether to grant approval. After giving approval, the committee will make a filing with the People's Bank of China (PBOC), whereupon the dealer will become a primary dealer.

■ **Non-dealers.** A non-dealer can only trade CRM instruments with primary dealers, and must do so for hedging purposes only.

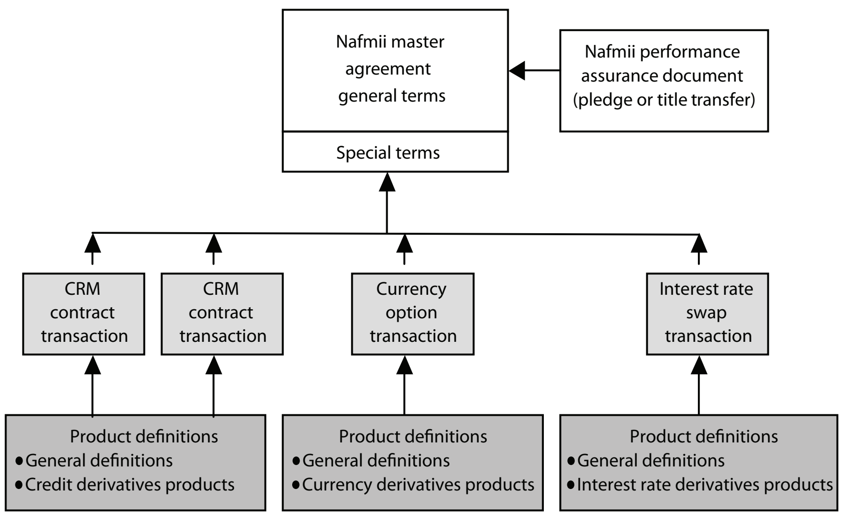
A market participant in the interbank credit derivatives market, which is neither a dealer nor a primary dealer, falls into the category of non-dealers. There are no particular filing or approval requirements for this type of participant.

It should be noted the guidelines only govern CRM instruments traded on the interbank market. As a result, dealers (currently most of which are banks) are not permitted to trade CRM instruments with non-dealers in the interbank market, but they (as banks) are generally competent under the current regulatory regime to transact OTC trades or credit-linked wealth management products with individuals and corporates outside the interbank market.

Are there any restrictions on trading CRM instruments?

One of the most notable features under the guidelines is the absence of a requirement for the buyer of protection to hold the reference obligation. In other words, there is no prohibition on naked short selling of CDSs – something that has caused plenty of controversy globally during the financial crisis. In any event, it is unlikely non-dealers can conduct naked CDS trades, as they would not meet the hedging requirement. In fact, this obligation means it is questionable whether non-

1 CRM contracts and Nafmii master agreement (2009)



Source: Linklaters

dealers can ever sell any credit protection.

The guidelines prohibit what is known as self-referencing credit derivatives – where the reference obligation under a CRM instrument is a debt obligation of any of the parties (including protection sellers and buyers) or their affiliates. Similarly, an issuer will not be able to issue CRM warrants referenced to its own or an affiliate's debt obligations, notwithstanding that the CRM warrants could be secured over security deposits or other collateral.

There are also various position limits under the guidelines:

- each dealer's net long (or short) position regarding any one reference obligation must be no more than 100% of its outstanding principal;
- its net short positions with respect to all the instruments it has entered into, issued or purchased shall not be more than 500% of its registered capital or net equity;
- the total market positions of all CRM warrants referencing any one reference obligation shall not be more than 500% of its outstanding principal.

Such limits are imposed to prevent a dealer from being over-exposed to a particular name, and to ensure the credit derivatives market does not grow out of proportion to the underlying bond market.

What document should be used?

Nafmii has published a suite of master derivatives agreements for OTC derivatives trading in the interbank market – the latest version was published in 2009. Parties should use this master agreement to document CRM contracts. The structure of the agreement is summarised in figure 1.

As shown, the Nafmii product definition booklet contains certain credit derivatives definitions (totalling around five pages). This segment only contains basic definitions and lacks a number of key provisions that have been widely adopted in the international credit markets. For example, there is no concept of grace period extension, notice delivery period or event determination date, and there are no provisions regarding the valuation process or delivery procedures.

The establishment of a determinations committee and adoption of auctions as the default settlement method have been two of the most important features of the July 2009 International Swaps and Derivatives Association supplement to the 2003 Isda credit derivatives definitions. These were added to address certain weaknesses in the credit derivatives market exposed during the global financial crisis.

Interestingly, while the Nafmii product definition booklet does not contain equivalent provisions, the guidelines contain references to auction settlement (the rules of which are to be published by the professional committee). The guidelines also state that if parties have a dispute over the occurrence of a credit event, they may request the professional committee to provide an opinion. Whether determination by the professional committee will be hardwired into CRM contracts in the future remains to be seen.

To improve liquidity and be eligible for central clearing, CDSs traded on the international markets contain certain common features, such as the credit event or succession event backstop date provisions. Premium payment dates and premium rates have also been fixed. There are no equivalent provisions in the product definition booklet or the guidelines, and it is unclear at this stage whether CRM contracts will become standardised over time in a similar manner.

As CRM warrants are tradable and transferrable instruments, they are very different from normal bilateral contracts from a documentation perspective. Simultaneously with the publication of the guidelines, Nafmii also released a new version of the Nafmii financial derivatives master agreement (warrant version) (figure 2) to resolve a technical issue unique to CRM warrants.

The warrant master agreement contains two parts: general terms and special terms. The general terms are identical to the Nafmii master agreement without its supplement (that is, without the schedule). The special terms contain provisions that reflect features peculiar to CRM warrants. These general and special terms together set out the contractual relationship between the CRM warrant issuer on the one hand and the CRM warrant holders on the other.

The warrant master agreement (consisting of general and special terms) and the "effective transaction agreement between the issuer and the holder" together constitute the entire agreement between the parties with respect to each CRM warrant. The "effective transaction agreement" for OTC derivatives under the Nafmii master agreement is normally the confirmation signed by the parties or the trade slips generated by the interbank trading system (that is, the China Foreign Exchange Trade System). However, under the guidelines, an issuer of a CRM warrant should prepare a warrant prospectus for each issue. This prospectus will include information on the reference entity, reference obligation, notional amount, credit events and settlement mechanism, and will be submitted to the Nafmii expert panel for examination and approval.

After the expert panel gives its consent to accept the issuer's application for the issuance of CRM warrants, the issuer will publish the CRM warrant disclosure documents on the Nafmii website. It seems the publication of the warrant prospectus can be regarded as evidence of an effective transaction agreement between the issuer and holders of the CRM warrants, which in turn forms part of the entire agreement with respect to the relevant CRM warrant.

Unlike the bilaterally executed Nafmii master agreement, the warrant master agreement adopts a multilateral execution approach. To this end, each market participant signs a warrant master agreement and deposits an executed copy with Nafmii. As a result, there is one unified contractual relationship – that is, the warrant master agreement (general terms and special terms) and the warrant prospectus as the effective transaction agreement – between the issuer on the one hand and all the holders on the other hand, and secondly, among all holders *inter se*. This unified contractual relationship helps to ensure CRM warrants are fungible and are freely transferrable on the interbank market.

Importantly, to achieve uniformity in the determination of credit events and settlement amount, and in the exercise of CRM warrant holders' rights, the special terms of the warrant master agreement dictate that when there are multiple holders of a CRM warrant, the investors shall collectively make relevant decisions and enforce their rights in relation to the occurrence of events of default and termination events. In contrast, if a CRM warrant has only a single holder, the investor and the issuer can deal with each other in accordance with the general terms of the warrant master agreement (that is, similar to the Nafmii master agreement).

Some observations

Under the Interim Administrative Rules Governing Derivative Activities of Financial Institutions (amended version effective as of July 3, 2007) and other applicable regulations issued by the China Banking Regulatory Commission (CBRC), a bank with derivatives approval from the CBRC is generally competent to transact derivatives (including credit derivatives) for hedging or for profit. This does not pose any issue in relation to the trading of CRM instruments contemplated in the credit derivatives guidelines.

However, the CBRC is currently looking to revamp the derivatives rules. It is possible that, under the new derivatives regulations, the CBRC may impose certain restrictions (such as type of products allowed and/or exposure limits) on an individual basis, taking into account, among other things, each bank's internal risk management capability. Such restrictions, if implemented, could have a substantial impact on the trading of the CRM instruments contemplated under the guidelines.

The interbank credit derivatives market is expected to create many new business opportunities – but there remain a number of unanswered questions. To name a few, will OTC credit derivatives and credit-linked wealth management products (targeted at individuals and corporate investors who do not have access to the interbank market) become more common? Will subsidiaries or branches of foreign banks (which are members of the interbank market) onshore in China be able to offer offshore clients access to the China credit derivatives market?

The past few months has seen concerted efforts by Chinese regulators to encourage financial innovation and to reform the local credit market, including the setting up of an interbank loan transfer market in Shanghai, granting Chinese listed banks access to the listed bonds market, and the establishment of credit assets exchanges in Tianjin and Beijing. To this end, the launch of credit derivatives in the interbank market is yet another giant step. Given the colossal size of the 8 trillion renminbi bond market and 40 trillion renminbi loan market, it will be interesting to see how quickly, and in what direction, the credit derivatives market in China evolves. ●

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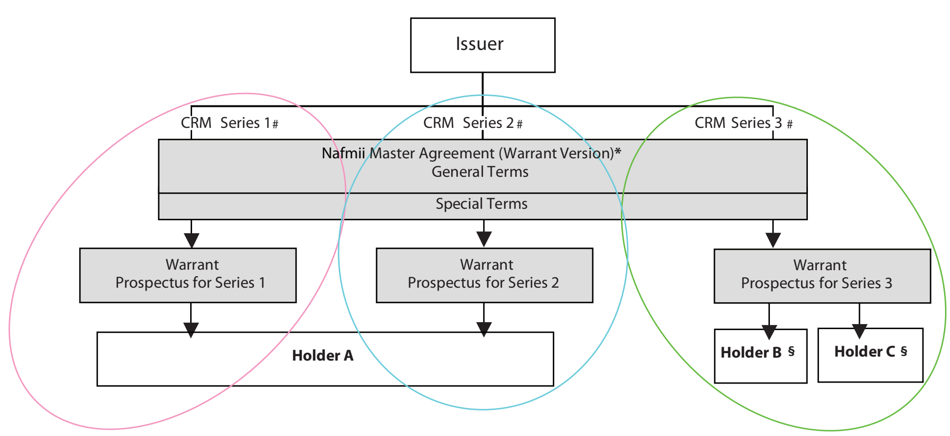
2 CRM warrants and Nafmii master agreement (warrant version)



* The warrant master agreements (including the general terms and the special terms) for different series of CRM warrants are standardised. The issuer only needs to sign one warrant master agreement for issuance of different CRM warrants.

\# The warrant master agreement and the warrant prospectus together form a complete agreement for each CRM warrant.

§ Holder B and Holder C shall take action collectively to early terminate series 3 CRM warrant.

Source: Linklaters