Faltering **growth**

China launched its version of the credit default swap market nearly 18 months ago – yet activity has almost ground to a halt due to a combination of inflexible rules, lack of standardisation and an approach to the concept of credit protection that is unique to China. By ***Viren Vaghela***

The onshore credit default swap (CDS) market in China started life with a fanfare in November 2010. Commercial banks, and smaller Chinese credit unions, were keen to start using the new hedging product. Nearly 18 months later, however, market participants say liquidity is non-existent and trading is effectively at a standstill.

When Shi Wenchao, secretary-general of the National Association of Financial Market Institutional Investors (Nafmii), a self-regulatory trade body, talked about CDSs in a speech to the domestic industry on November 16, 2010, he lauded the "simplicity and transparency" of the Chinese approach to this instrument.

But while he was describing CDSs, they were CDSs with a Chinese twist – products Shi hoped would enable domestic institutions to reap the benefits of credit default mitigation while sidestepping the systemic risks behind the US government's bail-out of American International Group in 2008.

The most obvious idiosyncrasy is the name. In China, the term 'default' is not welcome, as it implies the company on which the instrument is based is fundamentally risky – so it was rebranded the credit risk mitigation (CRM) market.

There are several reasons why the CRM market has not developed as rapidly as hoped. The first is that buyers can only obtain protection on individual bonds, rather than issuers, as in the CDS market. So, if an institution wants default protection on Ministry of Railways of China (MRC) debt, it must specify which of the agency's issues it wants to hedge. Given that the MRC issued four separate bonds last year alone, the result is a series of bespoke, inflexible contracts – with negative implications for liquidity. Today, CRM contracts are only quoted on 26 underlying bonds, says Gigi Tan, fixed-income and foreign exchange content specialist at Thomson Reuters.

The market will not develop unless the contracts can be standardised, says Zhai Chenxi, a credit trader at China Development Bank (CDB) in Beijing – but Nafmii recognises that, she adds. "The government wants to go step by step, but standardisation is a fundamental requirement to attract liquidity. Nafmii is starting to make it more standardised. In future we could buy a CRM on all kinds of bonds linked to one name," she says. Zhai stresses these views are hers, and not necessarily the bank's.

Traditionally, buyers of CDSs in the international market use the instrument for one of four reasons: risk reduction, balance-sheet management, speculation or arbitrage. In China, however, each of those strategies is either difficult to employ or is prohibited.

Firstly hedging: there are no records of defaults among Chinese corporates that would encourage bondholders to buy credit protection. With China's state-capitalism model, there is also the impression that all firms are backed by the government – but

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according to CDB's Zhai, the perception among investors that defaults cannot occur is misplaced.

"The bonds of large corporations in China are without an official guarantee and that is the reason why Nafmii developed the CRM market in 2010. Lots of bonds have been issued without guarantee," she says.

But according to Keith Noyes, regional director for the Asia-Pacific at the International Swaps and Derivatives Association, this view isn't widely shared among domestic bond investors. "Within China, there is the perception that most enterprises are government-backed. If all you are worried about is the credit, then if everything is backed by the central government you won't be a protection buyer," he says.

Investors should, of course, be aware that past performance is no guarantee of future performance, and CDB's Zhai says the absence of recent defaults does not remove the need for credit protection. "In the past three to five years, there were no defaults, but it doesn't mean there won't be any in future," she says. The lack of defaults goes some way to explaining why CRMs are relatively cheap compared with CDSs on their international peers.

Take the example of China Telecom: CRM protection on one of its five-year bonds costs 85 basis points. By contrast, PCCW, the Hong Kong telecoms provider, is trading at 194bp.

But while CRM cover appears cheap, this has more to do with the lack of buyers, says Thomson Reuters' Tan. Commercial banks, responsible for a big slice of volume in the global CDS market, are not active users of CRMs in China, for example.

The second traditional use of CDSs is balance-sheet management. Crucially for Chinese banks, there is a lack of clarity over how much capital relief they will receive if bond positions are hedged via a CRM. The China Banking Regulatory Commission (CBRC) has yet to provide specific guidance to commercial banks on capital relief – an area of concern for CDB's Zhai. "It is not clear what the percentage of capital relief is if we buy or sell CDSs," she says.

According to a source close to Nafmii, this situation should change soon, with the CBRC hoping to publish the final standards this year. "It takes time in the initial stage as you need market players to

be on board and regulators to recognise and implement rules for the product," says the source. The CBRC did not respond to questions by press time.

The third driver of demand for credit protection is speculation. In China, buyers of CRM protection are also required to own the underlying bond, making it difficult to use the product to express an outright short view. That stance may have seemed overly restrictive when compared with international rules, but is set to become more mainstream, with Europe edging towards a similar regime.

"Due to differences in CRMs and CDSs and because of negativity about the market, regulators are very conservative as they don't want to see risk accumulated," says one trader in China.

Structural arbitrage

The final source of demand for CDSs internationally is structural arbitrage: taking advantage of differences in spreads between a company's bonds and its CDS spread. A classic trade in single-name CDSs is to buy a bond and to buy protection on the issuer where the basis between the two is negative – that is, the CDS spread is lower than the bond spread. The investor holding a negative basis package would hope the CDS spread rises relative to the bond, allowing the package to be unwound at a profit, while being covered against default risk throughout. But market participants say the lack of liquidity in the Chinese market is hindering the development of this strategy and other, more complex strategies involving spreads between cash and CDS markets, or between different underlying credits (see box).

China also lacks fundamental infrastructure for its CRM market – chiefly, it has no determinations committee to rule on a credit event. Given that China has not experienced a corporate default since the development of the CRM market, there may be no pressing need for one to be established. But according to Thomson Reuters' Tan, it would be an important milestone in the establishment of China's CRM market.

"There are 26 corporate names being quoted in the CRM market today. However, there is no determinations committee framework in place, the feeling being that these corporates with ratings of triple-A or double-A minus aren't likely to default – but it's a chicken-and-egg problem in terms of market development," she says. "The market will need to quote lower-grade credits with higher perceived default risk to improve liquidity. A determinations committee process should ideally be in place so people will trade these lower-grade credits with confidence knowing there is a process to settle any default."

Crucially – and in contrast to the international CDS market – restructur-

A basis for growth?

The growth stories of many markets follow a relatively simple narrative: volume begets volume. As liquidity increases, participants become more confident about valuations and their ability to exit positions, or are able to use new types of trading strategy – and the resulting increase in activity creates a positive feedback loop, further boosting the market.

One of the strategies that could help China's credit risk mitigation (CRM) market is negative basis trading, market participants say – on the face of it, the opportunity is significant. "Despite the rapid growth of the Chinese bond market, there are many sellers of CRM products, but few buyers, so the negative basis is huge," says one trader in Beijing.

Where this basis appears in international credit default swap (CDS) markets, it is often a signal for investors to buy credit protection and the underlying bond in tandem, creating what is known as a negative basis package.

"A basis trade is a relative value bet based on the performance of the corporate bond compared with the CRM. A negative basis suggests one could buy the CRM – the equivalent of selling a bond – and at the same time buy the reference bond and bet that the CRM will widen relative to the bond," says Gigi Tan, fixed-income and foreign exchange content specialist at Thomson Reuters. If the trade plays out as hoped, the increase in the value of the credit protection will more than outweigh any decline in the value of the bond, allowing the package to be unwound at a profit without incurring credit risk on the bond.

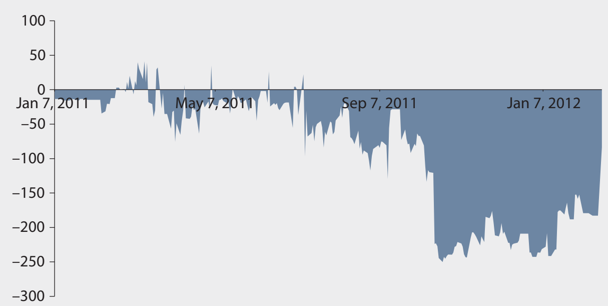
There are a variety of ways to compare the spread of the bond and that of the CDS, but one of the most common is to use the bond's asset swap spread, which is traditionally seen as a pure measure of credit risk, Tan says.

Using this approach, some of the negative basis opportunities in the CRM market look eye-catching. As an example, the three-year CRM on multinational electronics company TCL is trading at 160 basis points, while the three-year bond maturing in November 2014 is trading at a yield of 6.37% and an asset swap spread of 314bp – generating a negative basis of 154bp. A further example is Hunan Expressway (see figure 1), where the one-year CRM is trading at 140bp versus 224bp for the bond – a negative basis of 84bp.

However, the negative basis trade is based on the assumption that the credit spread should be similar for cash and CDS markets – and that is not necessarily the case, especially in China's still-young market. As the Beijing-based trader notes, CRM protection is cheap in part because there has been little demand for it to date. That could continue indefinitely.

Keith Noyes, regional director for the Asia-Pacific at the International Swaps and Derivatives Association, offers a different explanation: "One reason for the negative basis could be that people are treating the reference obligations as sovereign. Writing protection on them is considered free money," he says.

1 Hunan Expressway – negative basis



ing does not count as a credit event for CRMs. If this was changed, opening the door to arguments about whether tweaks to a specific bond count as a restructuring event, a determinations process would be vital to the credibility of the market.

Although Nafmii does not have a determinations committee, it does have a financial derivatives committee, which will be the basis for any determinations mechanism it establishes, according to a source close to the organisation.

Finally, several industry participants point out that Nafmii was pressing to establish the CRM market at a time when the CBRC was less keen on the idea, which led to a divergent view between the two regulators and may have slowed the publication of final CBRC rules.

"There is a bit of rivalry between the two regulators. Nafmii took the view that if it created a CDS market, it could push the corporate bond market – whereas the CBRC took the opposite view. This strategic difference could in part explain why the CBRC has not yet published its rules," says one Hong Kong-based banker.

Despite all these obstacles, CDB's Zhai has high hopes for the CRM market, arguing it simply needs time to be accepted and become standardised. She compares it with the onshore interest rate swap market, which was also a slow starter. "In 2006, CDB and another bank did the first interest rate swap deal, and in the following three years from 2006 the trading was low. But within the past two years, the volume of trading has grown considerably," she says. "Last year, the volume was above 2.6 trillion yuan [$413 billion] in the interest rate swap market."

She says onshore investors need to be educated about the risks of corporate bonds to make the CRM market more liquid – and the introduction of riskier bonds could help. "In recent weeks, news came that the high-yield bond market in China will be developed. And if this is the case then the CRM market will also boom," she says.

On the face of it, the market has some of the raw material it needs – corporate bond trading volumes in the Chinese interbank market have reached 20 trillion yuan, according to Zhai – and Nafmii remains convinced the market will take off.

"We believe there is a genuine demand for credit derivatives, and that's why Nafmii worked with our members to introduce this. But we want to make sure instruments are developed step by step and in a steady manner so we can ensure a big success, not turbulence," says a source close to the organisation.

Not everybody is convinced the market is ready. Isda's Noyes says: "Once you launch a product and it doesn't trade, it's hard to resuscitate it. We see this with attempts to take OTC products to exchanges, and when they don't trade people lose interest. Psychologically there may be an element of that as people geared up for it, invested in systems and hired people but nothing has happened. I'm of the belief that a liquid corporate bond market facilitates the growth of a CDS market, not the other way round. I remain bullish that China's CRM market will grow when the environmental factors are right." ■