CDS Is Coming To Town

Background: Chinese regulator gave green light to CDS

On Sep 23rd, the National Association of Financial Market Institutional Investors (NAFMII), a central bank unit that acts as a guild for the issuance of bonds and swaps published the revised version of the *'Business rules for the Pilot Operation of Credit Risk Mitigation Instruments in the Inter-bank Market*,' together with guidance on each of the Credit Risk Mitigation Agreement (CRMA), Credit Risk Mitigation Warrant (CRMW), Credit Default Swap (CDS) and Credit Linked Notes (CLN).

The first batch of CDS trade has consummated in Monday, Oct. 31. Over 10 institutions were involved in the 15 trades with notional principal amounting RMB 300 million. Since its debut back in 2010, the Chinese version of CDS has since seen little growth. The restart of the credit derivatives carries a far more resound implication, especially against the back drop of elevated credit risks.

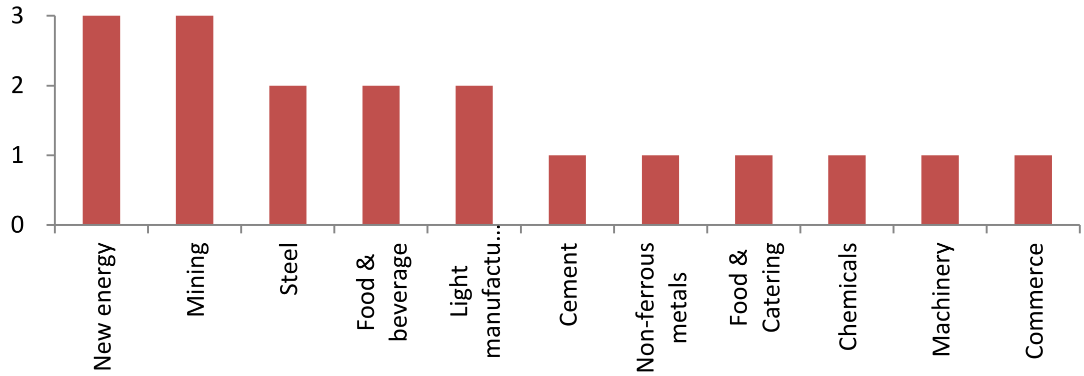
Chinese Credit Issue: More Frequent Defaults, Systemic Risk Unlikely

Since 2016, there have been 24 defaults across major bond types (commercial papers, super short-term commercial papers, medium-term notes, enterprise bonds, corporate bonds, and private placement notes), doubled that of 2015. Default entities include private companies, SOEs, and companies owned by regional governments. Only Local Government Funding Vehicles ("LGFV") debt remains intact.

Defaulting issuers in 2016 concentrated into three categories: over-capacity SOEs in heavy industries such as steel, coal, and cement; renewable energy industries such as solar and wind power; and privately-owned light manufacturing firms and consumer firms. Corporate governance issues were common among the default entities.

Among the 18 companies that defaulted on their obligations, no bond types were immune from the credit risk outbreak, including Short Term Commercial Papers (SCPs). Rating-wise, AA issuers accounted for 65% of the defaults, and AA+ and AA- account for 18%. None of the AAA rated issuers report defaults. There is no precedent of an AAA issuer default.

Exhibit 1: Number of Bond Defaults by Sector



Source: Wind

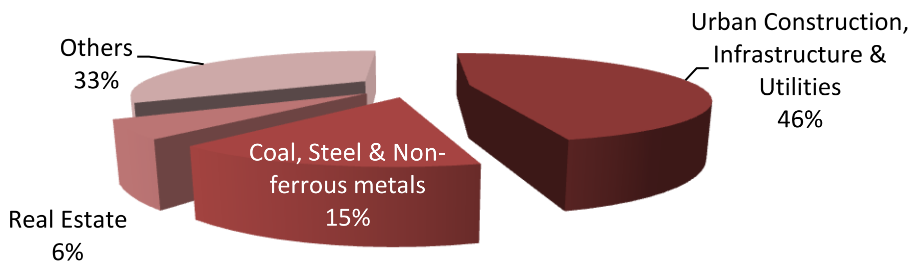
Internally, against the backdrop of macro economy slide and overcapacity issues, corporate earnings deterioration and operating cash flow decline pushed up demand for external financing. Burdened by more indebtedness, the repayment ability further weakens.

Externally, the de-capacity effort made refinancing and rolling over of borrowing more challenging. Bond investor taking refuge in safety has led to widening credit spread and even cases of unsuccessful credit bond issuance.

Yet, such defaults are unlikely to trigger systemic risks. Total value of defaults is still minimal, representing merely 0.2% of total credit bond value outstanding, and 0.02% of total social financing outstanding.

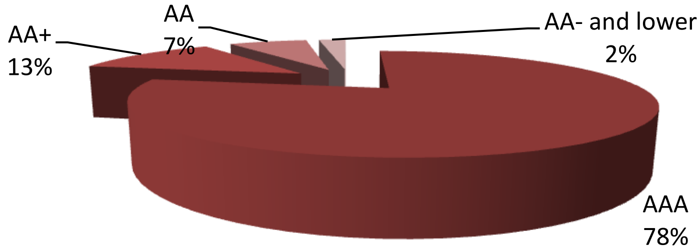
The less risky bond classes, such as LGFV bonds, utilities, account for roughly 46%, with 15% for overcapacity industries. Among over capacity issues, 78% are AAA rated bonds and less than 10% are rated AA or below.

Exhibit 2: Term Bonds Market by Issuer Type



Source: Wind

Exhibit 3: Credit Rating of Outstanding Bonds in Overcapacity Industries



Source: Wind

Bond default hedging instruments such as credit risk mitigation warrants (CRMW) were launched in the domestic market in as early as 2010. However, trading of such credit hedging instruments was quite light, mainly owing to the fact that the protection these instruments offer are on a single name basis. Also back in 2010, the outbreak of credit events were deemed remote to investors, hence no market participants considered it the protection against credit risks. The early CRMWs are mainly issued on investment quality bonds with at least AA+ rating, some issuers are even prominent SOEs with near nil chance of defaulting, hence the attractiveness of the hedging instruments were further diminished.

Exhibit 4: CRMWs currently trading in the market

Code	Description	Underlying Bond	Bond Rating	Notional (RMB Million)	Inception Date
021001002.IB	CHINA BOND INSURANCE B110920	10 China Unicom CP02	A-1	100	2010/11/24
021006001.IB	INDUSTRIAL BANK B111013	10 PZH Steel CP02	A-1	50	2010/12/31
021001001.IB	CHINA BOND INSURANCE B130920	10 China Unicom MTN1	AAA	130	2010/11/24
021002001.IB	BOCOM B110818	10TCLCP01	A-1	50	2010/11/24
021003001.IB	CMBC B111020	10 Yunnan Copper CP01	A-1	200	2010/11/23
021001003.IB	CHINA BOND INSURANCE B120827	09 TH Holding MTN1	AA+	100	2010/12/31
021004001.IB	HSBC BANK(CHINA) B111227	10 CNPC MTN3	AAA	10	2010/12/27
021005001.IB	SPDB B111129	10 ZhengZhou Coal CP01	A-1	50	2010/12/30
021101001.IB	CHINA BOND INSURANCE B111119	10 GanYue Expressway CP03	A-1	50	2011/3/23
021607001.IB	CHINA SECURITIES B230905	16 Nongying 1Preferred	AAA	800	2016/8/31

Source: Wind

Exhibit 5: Key changes from the 2010 version of Guidelines for the Pilot Operation of Credit Risk Mitigation Instruments in the Inter-bank Market

	'Guidelines for the Pilot Operation of Credit Risk Mitigation Instruments in the Inter-bank Market-2010'	***'Business rules for the Pilot Operation of Credit Risk Mitigation Instruments in the Inter-bank Market-2016'***
Instrument Covered	Credit Risk Mitigation Agreement (CRMA) and Credit Risk Mitigation Warrant (CRMW)	CRMA, CRMW, Credit Default Swap (CDS) and Credit Linked Note (CLN)
Deregulation of market participant criteria	A Three-tiered participant structure: Dealer, Core Dealer and Non-dealer participant ● 4 Billion RMB in paid-in capital for core dealer, who has to be market makers in the interbank bond and FX market, mainly large commercial banks ● 800 Million RMB in paid-in capital for dealer ● Non-dealer can only enter hedging trades with core dealer	A simplified two-tiered participant structure: Core and regular dealer ● Core dealers include Financial Institutions andqualified credit enhancement institutions; they are allowed to act as counterparties to all credit instrument trades. ● Regular dealers include non-financial institutions and individual products. They are only allowed to trade with core dealers
Underlying obligation type	Bonds or other similar debt obligations	Bonds, Loans or other similar debt obligations
Deregulation of product inception	A registration system for CRMW product inception, and the product is subject to approval by the Interbank Financial derivatives experts'	A filing system for CRMW and CLN product inception. The expert committee has been removed. NAFMII will only review the discourse

	committee	of the incepted product.
Risk Measures	• For all dealers, total notional of CRM instrument bought or sold shall not exceed 100% of the underlying obligation or 500% of its paid-in capital • Total notional of CRM instrument incepted shall not exceed 500% of the underlying obligation	• For core dealer, total notional of CRM instrument sold shall not exceed 500% of its paid-in capital • For regular dealer, total notational of CRM sold shall not exceed 100% of relevant product or net assets.

Source: NAFMII

The recently announced CDS and CLN aim to hedge the credit risks associated the issuer, rather than a single issue. The coverage expands to both the existing and future issues by the same issuer. For CDSs, the definition of credit events got expanded from payment default, bankruptcy, to further cover other credit events such as accelerated repayment and debt reorganizations.

Exhibit 6: Cross comparison between different credit hedging instruments

Type	Name	Full Description	Reference Entity	Credit Event Coverage
OTC Contract	CRMA	Credit Risk Mitigation Agreement	Single Bond Issues	Payment default, Bankruptcy,
	CDS	Credit Default Swap	By Issuer(include but not limit to corporations, companies, LPs Sovereigns and Supernationals), Covering single or multiple issues, Possible to extend beyond NAFMII registered instrument types (currently CPs, MTNs SCP and etc.)	Payment default, Bankruptcy, and other credit event such as accelerated maturity, and debt reorganization.
Standardized Tradable Instrument	CRMW	Credit Risk Mitigation Warrant	Single Bond Issues	Payment default, Bankruptcy,
	CLN	Credit Linked Note	Same as CDS	Same as CDS

Source: NAFMII

Implications

The renewed business rule of credit risk mitigation instruments marks a milestone in China's fixed income market. Credits risk, which in the past has curbed many investors from entering the credit space, can now be effectively managed. The emergence of credit derivatives also help with the formation of a pricing mechanism for credit risks, by providing price discovery. A concern is that although the credit risks are dispersed and decentralized, the risk extension in the participation chain may be a double-edge sword in providing tools for opportunist guarantors who will exploit continual payments but just announce bankruptcy at defaults, thus further amplifying risks in times of crisis. The regulators have foreseen its possible occurrence and assimilated the wisdom from the 2008 US credit risk outburst by limiting the underlying asset to AAA ratings at this preliminary stage. It is reasonable to have enhanced confidence in China bond market as the NAFMII is taking a prudent position with future underlying asset not likely to expand to non-investment grade and further protection announcement anticipated.

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