New CDS markets emerging

Asian CDS volumes remain subdued, due to limited corporate bond markets and tight regulatory measures. However, emerging CDS regimes in China and India could spark increased activity in the sector. **Anna Carlisle** investigates

Asian CDS volumes are subdued: liquidity is sluggish and flow – although limited – is driven by the G14 banks rather than domestic players. While the lack of activity is due to limited corporate bond markets in the region, tight regulatory measures and a fear of market destabilisation post-financial crisis are also said to be inhibiting growth. However, there is promise of increased activity, albeit domestic: India is due to launch a domestic CDS market in October, while China is hoping to re-launch its semi-nascent market following a reconfiguration of the documentation.

"Most of the credit exposure in Asia is held by banks who actually like the risk," says risk consultant Satyajit Das. "They have a lot of capital, are awash with liquidity and are looking for ways to invest in interest-bearing assets. There is no reason for them to buy protection because they essentially want the risk and there's little reason for them to sell protection because they want physical assets, and a leveraged trade on credit is less attractive."


Satyajit Das, risk consultant

According to DTCC data, only about 20 Asian names trade more than 20 times a day globally. The credit indices are traded more often, however, with banks now using the indices to hedge their loan books. Further impetus is expected to be added to the indices with the introduction of central clearing for iTraxx Japan through the Japan Securities Clearing Corporation (JSCC) later this year.

The dominance of the G14 banks in Asian CDS is exemplified by the current constituents of the ISDA credit determination committee in Japan, where just one of the two regional dealers on the board is Japanese. The committee members are selected based on the previous year's market volume.

"In Asia ex-Japan [determination] committees, there's not a single Asian bank that makes it onto a determinations committee, reflecting that the Asian market is still dominated by global dealers," says Keith Noyes, regional director, Asia Pacific at ISDA. "For the purposes of CDS, regional banks are really treated as end clients rather than dealers."

Indeed, the global dealers that are active in Asia have become more powerful, says Das – although liquidity is actually lower now than it was pre-crisis. Trading has also become more concentrated on fewer reference entities.

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Before the crisis there were approximately 200-300 names that traded with some frequency, but now that number is significantly lower. The number of active market participants on the investor side has also diminished as accounts' internal credit committees have become more cautious about CDS.

"There's a lot of angst over the documentation problems," suggests Das. "When Greek bonds essentially default and you can't trigger your CDS because it's a voluntary restructuring, [it] creates a lot of concern over what this market actually is and does. Realistically, this does not help develop the market globally. Unless ISDA is willing to debate these issues in an open and transparent manner, it makes it difficult for the CDS market to progress or even regain the position it held pre-GFC."

While the regulatory regime in Asia is also deemed overly rigorous in terms of allowing new instruments, a further blow to a viable future in this market is that most of the credit exposure held in this region is in local currency. Over 95% of the global CDS market is either denominated in US dollars or euros.

"Asia, at its central banks, is extremely cautious of liberalising, though they pay lip service to liberalisation," says Das. "Essentially, the regulators in the region are very wary of anything that looks even vaguely like it could destabilise markets and in the aftermath of 2007 and 2008 they have become even more cautious. Reading between the lines, they don't really want to sponsor or preside over a large active CDS market. Their hearts are not in it."

New frontiers

Nevertheless, India and China have shown enough interest in CDS to undertake the launch of the product domestically. While there is currently a small off-shore CDS market for a limited number of Indian names that have foreign currency denominated debt, such as Tata, the State Bank of India has initiated the launch of a Rupee-denominated on-shore CDS market referencing Rupee bonds, which is due to open on 24 October.

The Indian market will have two parts. There will be an end user to market maker segment, where a buyer buys protection from a market maker and the maturity of the protection exactly matches the maturity of the underlying bond. The buyer must own the underlying bond. Also, at present the end users are prohibited from selling CDS.

The second part of the market will consist of an interdealer market, where the selling of naked long and short CDS is permitted. This market is intended to trade like the global market, with quarterly roll dates and standardised coupons. But it will be subject to two types of documentation – international and Indian.

"Structurally, one of the biggest problems facing this market is that there are no natural protection sellers out there," says Noyes. "It will all come down to relying on the bank market makers to sell the protection, and their activity will be capped by their risk limits. The banks will hit these limits quickly as there are no natural hedges and no availability to issue CLNs."

In a similar move, NAFMII (National Association of Financial Market Institutional Investors) – which is run by the People's Bank of China – introduced a version of a CDS market in China last year, dubbed Credit Risk Mitigation Instruments or CRMs *(SCI 1 December 2010)*. While the initial launch day saw a fair amount of notional volume traded, there has been – at best – sporadic trading of the product since.

Problems have included a lack of clarity over who could and could not trade: the China Banking Regulatory Committee (CBRC) did not make it clear at the outset if it would allow banks to trade the product, for example. Also, domestic CRM does not recognise restructuring as a credit event, so the product has to be traded differently to CDS on Chinese off-shore names.

"Fundamentally there is no fungibility between the two," says Noyes. "Hedge funds could potentially be a source of liquidity for the product, but banks would hesitate to sell protection in China after sourcing protection offshore as the domestic and international products are so different."

He adds: "There's also a legal basis risk: offshore a determinations committee would determine whether a credit event had or had not occurred, while onshore documentation only says that if the protection buyer and seller fail to agree, they can refer the dispute to a committee to be set up by NAFMII in the future."

In an attempt to re-launch this market, the CBRC and NAFMII have agreed that NAFMII will take the lead in publishing additional definitions for China's CRM market. But whether the Chinese product will be a success when re-configured remains to be seen.

"If it looks more like the international version, it may have more success," says Noyes. "However, the legal basis risk will remain. Buyers and sellers of the protection will be subject to one agreement under Chinese law, and another under international law."

He concludes: "The other issue of where to source protection also remains unclear, meaning there is still the risk of a one-way market."

Aussie RMBS revival on track

The recovery in the Australian RMBS market has been given further impetus by the return of cross-border investors. Whether the sector can withstand the pressure of deteriorating fundamentals remains to be seen, however. **Anna Carlisle** reports

Australian RMBS market fundamentals are under scrutiny as household leverage and prime mortgage delinquencies continue to rise. Nevertheless, 2011 has been a positive year for domestic issuance, while investor interest from further afield has resulted in the launch of the first Australian RMBS with a Japanese Yen-denominated tranche.

"Torrens Trust was the first Australian RMBS to offer a JPY-denominated tranche," confirms Jennifer Wu, vp at Moody's. "We've had a lot of enquiries recently from Japanese investors about Australian RMBS as the yield is more attractive than Japan. The investors are also happy with the performance of Australian mortgages."

She adds: "If from a cost perspective it makes sense, then it is possible there will be more Australian RMBS issued with a Yen tranche. But from my observation, it appears that some investors – particularly in Europe – are tending to revert to their home countries where they are more familiar with the product and also where they can perform more in-house analysis.

"It is possible there will be more Australian RMBS issued with a Yen tranche"

Also, new regulatory measures are not fully settled yet, such as CRD 4 or skin-in-the-game requirements."

Alex Sell, Australian Securitisation Forum

Other investor preferences are being incorporated into new RMBS transactions from the region. For example, a number of current transactions are being structured with subordinated triple-A tranches – each with a different weighted average maturity to suit investor preference.

Investors are also now actively looking for notes that are eligible for inclusion in the UBS Composite Bond Index. "Certain notes have been issued with a soft bullet tranche: the legal final maturity of the notes will remain, but the transaction has a refinance mechanism," Wu says.

According to Alex Sell, coo of the Australian Securitisation Forum, the hierarchy of investor demand has changed geographically. Whereas in the past European investors bought a lot of euro-denominated Australian RMBS paper, now there is more US and Asian interest – hence the Yen tranche in the recent Torrens deal.

Investors consider APAC structured credit return

The secondary CDO market in Australia has been subject to increased investor interest in recent months alongside a re-emergence of demand for simple structured products. While volumes are still relatively low, market participants point to improved sentiment in the region.

According to Structured Credit Research & Advisory director Moray Vincent, the secondary market for synthetic CDOs in Australia is recovering post-financial crisis, thanks to a combination of different factors. First, he points to the credit professionals who left the banking sector during the crisis that have raised capital and launched their own hedge funds looking at structured products.

"These offshore funds have picked the low-hanging fruit in the major markets (US and Europe) and are now looking further afield – i.e. Australia," he says. "Previously these funds weren't interested in looking at opportunities in Australia, but now there is reasonable interest."

Second, Vincent says there are more buyers and sellers taking advice from specialist companies, meaning that there is a lot more transparency as to what certain structured products are actually worth – thus facilitating a tighter bid-offer spread. "In most cases, this actually means there is a bid and an offer," he says.

He continues: "Liquidity has increased: if you want to sell, you can. However, in our opinion, if you do sell you will still do so at a discount to fair value in most cases – although that discount is getting smaller. There are still more sellers than buyers, so products will sell on the bid side for the time being."

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Moray Vincent, Structured Credit Research & Advisory

Risk consultant Satyajit Das adds that liquidity in secondary market CDOs in Australia is very sporadic. "You have to go back to a real underlying issue that is there never has been much liquidity in CDOs – just interest at given points in time. Fundamentally, that hasn't changed a great deal," he says.

Meanwhile, liquidity has also increased in certain Lehman-arranged synthetic CDOs, even though they are still subject to legal disputes. "Certain investors are venturing into an area where they are willing to take legal risk on court outcomes," says Vincent.

The renewed interest in the Lehman-arranged deals comes off the back of a ruling in May this year, where Perpetual Trustee Company disclosed that investors from Australia, New Zealand and Papua New Guinea for whom it acts as trustee in CLNs issued by Mahogany Capital would receive up to 85 cents in the dollar of principal on the Mahogany Series I notes and 69 cents on the Mahogany Series II notes. This follows the settlement with Lehman Brothers Special Financing in November *(SCI 3 December 2010)*.

Away from secondary interest, demand is also emerging for new structured products, although mainly from high net-worth individuals and sophisticated investors. New products under construction include simple CLNs or equity-linked products with a principal guarantee. Often the products are structured to be tax efficient.

"Demand is by no means a floodgate. But, at the same time, it is more than just green shoots," says Vincent.

"This is partly down to pricing issues, but also due to a lot of real money investors in Europe being put off debt markets in general by the continuing sovereign crisis," he says.

Regulatory developments in Australia have benefitted the RMBS market over the past few months. For example, the central bank's introduction of a Committed Secured Liquidity Facility means that, for a fee, RMBS can now be posted as collateral for Basel liquidity purposes.

"Due to this, the banks have been issuing large amounts of RMBS and buying each other's issues, safe in the knowledge that they can post the paper for cash liquidity," adds Sell.

He continues: "Another potential boost for RMBS is the narrowing of the pricing differential between senior unsecured and RMBS. If a bank is downgraded and the cost of funding goes up, it puts RMBS in a much better pricing light."

Non-bank issuers, meanwhile, have continued to benefit

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from the Australian Office of Financial Management's (AOFM) funding initiative *(SCI passim)*. The programme's final A$4bn was announced at the end of December last year and is due to be deployed over the coming months.

The ASF has advocated for more innovation with the AOFM's involvement in RMBS, however. For example, it has suggested that the AOFM fund the longer-dated A3/AB tranche of a deal to allow a bullet fixed-rate tranche to be issued at economic levels higher up the capital structure.

Meanwhile, concerns over market fundamentals in Australia persist. Both Moody's and Fitch have embarked on reviews of their rating methodologies in the past few months, citing increasing household leverage and increasing prime mortgage delinquencies *(SCI 10 August)*. S&P also started a review at the end of 2010.

Moody's anticipates increases in mortgage default probabilities and house price stress rate assumptions. It also highlights Australia's economic growth being increasingly driven by favourable terms of trade.

"The commodities-led structural transformation that the economy will undergo over the next two decades implies both winners and losers, with certain industries and geographical regions coming under significant pressure," the agency says. "As a result, default and delinquency rates in the mortgage market are likely to be variable and, in our view, on average higher over the coming decade than in the past."

Jerome Cheng, Moody's

Sell agrees that arrears are picking up, but confirms that relatively speaking they are still low. "Although the cynics say that Australia is not immune from a housing market crash, the consensus is that it should remain resilient due to full employment, net inward migration and housing supply shortage," he says.

Wu expects domestic RMBS issuance to stay positive in the region for the rest of 2011, but does not expect any huge spike. "I would expect to see a couple of very bulky issuances from the banks, followed by a few smaller deals before year-end," she says.

Korea leads the way in ABS

Away from Australia, primary ABS issuance in Asia ex-Japan has picked up significantly post-financial crisis. Issuance in 2010 topped US$5bn, while issuance in 2011 has already exceeded that mark. According to Jerome Cheng, vp at Moody's, issuance has been fuelled by the return of the Korean ABS market (auto and credit card-backed) and Taiwanese repack notes.

A combination of favourable pricing levels and investor appetite is bolstering demand. "A number of Korean triple-A rated ABS transactions in the first half of 2011 were priced at below 100bp," he says. "The pricing of the currency swap also gave additional saving to the sponsor. There is also strong interest in the transactions from investors: there are existing investors buying deals, as well as new investors from Japan, Australia and America."

Meanwhile, the Korean covered bond market is making ground. To date, Kookmin Bank and KFHC have each sponsored one covered bond deal, while another is expected from KFHC before year end.

"Looking ahead, the development of Korean covered bonds is positive as the Financial Supervisory Commission (FSC) and Financial Supervisory Service (FSS) have recently issued their covered bond guidelines, which may act as the catalyst for future issuance of this asset class," adds Cheng.

Elsewhere in the region, the Japanese market also remains buoyant, with fewer, larger transactions in recent months. Regular monthly RMBS notes by the Japan Housing Financing Agency alongside the refinancing of ABS transactions backed by consumer loans are driving issuance volumes.

But Singapore – once a hub of CMBS activity – has seen just one transaction come to market in 2011: Silver Oak. "Singapore will most likely see isolated transactions, as pricing is still relatively expensive for the sponsor," concludes Cheng. "Sponsors are considering different funding routes, such as equity issuance, other capital market solutions or bank borrowing." SCI