# Launch of CDS in the PRC: a seismic shift

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Depending on whom you ask, debt levels in China today stand at around 250% of GDP. Whilst this is not the highest debt-to-GDP ratio in the world, the PRC authorities are taking action. As one of several measures introduced recently, early November 2016 saw the first trading of Credit Default Swaps (CDS) on the China Interbank Market.

### What is a CDS?

A credit default swap is an OTC credit derivative which enables market participants to transfer or redistribute credit risk. Put simply, one party (the buyer of protection) pays a periodic fee (a 'premium') and/or an upfront payment to the other party (the seller). In exchange, if a 'Credit event' (such as insolvency) occurs in relation to a named reference entity, the seller makes a payment to the buyer. The market price of the premium is an indication of the perceived risk related to the reference entity.

### Has China had CDS before?

In 2010, the National Association of Financial Market Institutional Investors (**NAFMII**) in the PRC launched a variety of onshore credit risk mitigation tools (**CRM**). The range of CRM products was limited and ultimately trading volumes were low, perhaps because at the time China was experiencing meteoric economic growth and rising corporate profits. The prevailing sentiment at the time was that the government offered an implicit guarantee for bond repayments, a view fuelled by cases such as Shanghai Chaori Solar Energy Science & Technology Co. Made famous (or perhaps infamous) by being the first defaulter in the Chinese onshore bond market, Chaori Solar's default was resolved without any haircut for investors after the company obtained a guarantee to help make repayments from a state-backed fund.

Against this backdrop, Chinese bonds were regarded as almost risk-free.

### So what changed?

Quite simply, the economic climate in China has changed. Growth is slowing (particularly in the real estate sector) and reforms to cut industrial overcapacity have begun to bite. Whilst defaults in China are still at a relatively low level compared to other countries, the level is rising. An increasing number of Chinese companies are struggling to make payments on their debt and the figures make for sobering reading as the number of court bankruptcy cases involving debt soar. There has been a rise in both the number of non-performing loans and the ratio of bad loans plus a slew of ratings downgrades.

To add to this, default in China has some complicating features. There are few processes through which non-payment issues can be resolved and investors face long delays and challenges in recovering even a proportion of their investment. Certainly, the previously held assumption that issuers were effectively guaranteed by the state now offers scant comfort. Investors face an outcome that is, at best, uncertain with offshore investors feeling particularly vulnerable.

What were once seen as "risk free" bonds are looking "risk free" no longer.

**A small (but important) step**

This new PRC CDS market is small and the variety of market participants limited. The first trading saw 15 trades between ten financial institutions on the China Interbank Market. With PRC banks being major players in the Chinese fixed income market, it makes sense that they are key participants but this does mean that the risks remain within the banking system. If, going forward, the CDS market operates in a way that satisfies the PRC authorities, we expect to see CDS being made available to more banks and a wider range of market participants (including insurance companies). But this won't happen overnight.

The start of CDS trading in China has raised perhaps more questions than it answers. Who are the market participants? What is the documentation? Will it follow the international credit derivatives market (e.g. on the definition of "Credit Event" and close-out process)? What about pricing? What about risk weighting for the assets on which protection has been bought?

But neither the small size of the CDS market nor the current lack of answers to these questions should overshadow the importance of this move. Anyone foolish enough to think that the PRC authorities are looking to create a market-driven financial system will be sorely disappointed but by introducing CDS, the PRC authorities are signalling that they are prepared to allow a gradual normalisation of credit default. This is a seismic shift.

**Tools to manage debt**

CDS is one of several measures being introduced to manage corporate debt in China. Others include:

**PRC Bankruptcy Law:**

Debt-laden "zombie" companies have been a blot on the landscape in China for some time and procedures under the PRC Bankruptcy Law are increasingly being used to resolve defaults on bonds (for example, Bading Tianwei Group and Dongbei Special Steel Group).

**Debt-for-equity swaps:**

October 2016 saw the announcement of guidelines for reducing rising corporate debt levels through debt-equity swaps, although the National Development and Reform Commission (**NDRC**) stressed that these will only be available to high quality firms that face temporary difficulties.

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