

# Results of the 2002 Survey on Credit Derivatives Activity

by the Banking Policy Department

The HKMA has completed a survey on credit derivatives activity in the banking sector. The survey covered all licensed banks and restricted licence banks (RLBs) at the end of October 2002. The survey results show that the participation of local banks in the credit derivatives market has increased in the past three years, although their exposure is still relatively small. Market activity is highly concentrated on a few authorized institutions (AIs).

## INTRODUCTION

Credit derivatives allow market participants to transfer credit risk on loans and other assets through buying and selling these financial instruments. According to the 2001 Triennial Survey of Foreign Exchange and Derivatives Market Activity conducted by the Bank for International Settlements, the global credit derivatives market has evolved rapidly both in terms of volume and product complexity.<sup>1</sup>

The HKMA conducted its first survey on the credit derivatives activity of locally incorporated AIs in 1999.<sup>2</sup> In order to provide a more complete picture, the recent survey, conducted in November last year, covered all licensed banks and RLBs, as at end-October 2002.

The survey collected information on credit derivatives transactions on the basis of both executions and booking in Hong Kong, with a breakdown by nature, product, maturity, reference entity and counterparty. The surveyed AIs also reported on the purpose of their credit derivatives operations and plans to commence or expand such operations in the future.

## MAJOR FINDINGS

### Credit Derivatives Positions in AIs

A total of 45 AIs, comprising nine local banks, 29 foreign bank branches and seven RLB subsidiaries of foreign banks, reported that they had credit derivatives operations. Only six maintained positions in the trading book. The aggregate gross positions of all surveyed AIs amounted to HK\$143 billion as at end-October 2002. Table 1 provides a breakdown of the positions.

**TABLE 1**  
Positions of All Surveyed AIs (in HK\$ Mn)<sup>3</sup>

	Buying protection	Selling protection	Total gross positions
Trading Book	67,370	56,971	124,341
Banking Book	5,186	13,741	18,928
<b>Total</b>	<b>72,557</b>	<b>70,712</b>	<b>143,269</b>

The results of the survey reveal that market activity is highly concentrated with the top four AIs accounting for more than 80% of the aggregate gross positions. The market is dominated by foreign bank players,

<sup>1</sup> The Survey indicated a rapid expansion of the market for credit derivatives, with outstanding positions in these instruments increasing from US\$108 billion as at end-June 1998 to US\$695 billion as at end-June 2001. The survey covered 48 economies including Hong Kong.

<sup>2</sup> The results of the 1999 survey have not been published.

<sup>3</sup> (i) The reported positions include those that were executed in Hong Kong but booked in other overseas centres.

(ii) There is an element of double counting in the aggregate gross positions reported. If the protection buyer and the protection seller of a credit derivatives transaction are both surveyed AIs, the same transaction is reported under "buying protection" and "selling protection" respectively.

which constitute 94% of the aggregate gross positions reported. The transactions of the major foreign bank players are predominantly for trading purposes and most of their positions are not booked in Hong Kong.

There are nine local banks with outstanding credit derivatives positions (compared with seven in the 1999 survey<sup>4</sup>). Five are new players. While the local banks still account for a small share of credit derivatives transactions (6%), their level of interest and participation in this activity has increased, as evidenced by the expansion of the size of their positions. The aggregate gross positions (in both the trading book and the banking book) of the local banks increased by 203% compared with the positions surveyed in 1999. Nevertheless, their exposure to credit derivatives on an individual bank basis is generally low. For most of the local banks, the percentage of their gross positions to capital base is below 10%. In contrast to the major foreign bank players, the local banks mainly take positions in the banking book as protection sellers. Many of them take on credit exposure through the purchase of credit-linked notes in the banking book for yield enhancement purposes.

## Product Types

Credit default swaps and credit-linked notes (mainly for the local banks)<sup>5</sup> are the two most common types of instruments used by the surveyed AIs (Table 2). In addition, there is growing interest in other credit derivatives products, for example, collateralised debt/loan obligations.

TABLE 2

Percentage Share by Type of Product

Credit derivative products	All surveyed AIs
Credit default swap	85.7%
Total return swap	0.1%
Credit spread product	3.4%
Credit-linked note	7.2%
Collateralised debt/loan obligations	0.6%
Others	3.0%

## Maturity of Outstanding Positions

The positions are predominantly medium term, i.e. one to five years (Table 3).

TABLE 3

Percentage Share by Maturity

Maturity of outstanding positions	All surveyed AIs
Within 1 year	17.8%
From 1 to 5 years	75.1%
Over 5 years	7.2%

Note: Because of rounding, the figures set out in this table may not add up.

## Reference Entities

The reference entities of AIs' credit derivatives products are spread over corporates, banks, and central governments and central banks (Table 4).

TABLE 4

Percentage Share by Type of Reference Entity

Reference entities	All surveyed AIs
Central governments & central banks	33.9%
Public sector entities	0.3%
Banks	20.9%
Corporates	44.1%
Others	0.8%

<sup>4</sup> Three of the local banks that had credit derivatives positions in the 1999 survey did not report any position in the 2002 survey.

<sup>5</sup> 50.2% of the credit derivatives positions reported by local banks are in the form of credit-linked notes.

Most of the reference entities are located in Hong Kong and Asian countries, including South Korea and Mainland China (Table 5).

**TABLE 5**  
Percentage Share By Geographical Location of Reference Entities

Geographical location of reference entities	All surveyed AIs
Hong Kong	20.0%
Mainland China	13.1%
Japan	2.4%
South Korea	32.8%
Other Asian countries	28.8%
Others	3.0%

Note: Because of rounding, the figures set out in this table may not add up.

## Counterparties

Overseas financial institutions are the most common type of counterparties of the surveyed AIs (85.9%). The counterparties located in Hong Kong are mainly AIs and securities firms, each accounting for 5.2% of all counterparties (Table 6).

**TABLE 6**  
Percentage Share by Type of Counterparty

Counterparties	All surveyed AIs
AIs in Hong Kong	5.2%
Other non-AI counterparties in Hong Kong	6.2%
of which securities firms	5.2%
insurance firms	0%
others	1.1%
Overseas financial institutions	85.9%
Others	2.8%

Note: Because of rounding, the figures set out in this table may not add up.

## Purpose of Current Operations

For most of the local banks and foreign AIs, the sole purpose of their credit derivatives operations is to take on credit exposure. The major foreign bank players in this market also use credit derivatives for hedging, trading and marketing purposes.

## Future Plans on Credit Derivatives Operations

Six local banks that did not report any credit derivatives transactions in this survey expressed the intention to commence credit derivatives operations for taking on credit exposure, hedging and trading purposes. A few local banks that have maintained credit derivatives operations indicated plans to expand their operations for hedging, trading and marketing purposes. Some foreign AIs also intended to commence credit derivatives operations in the future.

## CONCLUSION

The survey results show that the participation of local banks in the credit derivatives market has increased in the past three years, although their exposure is still relatively small. Because of the current low interest rate environment and sluggish domestic loan demand, it is likely that local banks will seek to further increase their exposures to credit derivatives for yield enhancement purposes. In order to effectively monitor developments in the credit derivatives market and the involvement of AIs in these activities, the HKMA will now conduct the survey on an annual basis.