

Results of the 2005 survey on credit derivative and securitisation activities

by the Banking Policy Department

The overall level of activity of authorized institutions (AIs) in the credit derivative and securitisation markets in the 2005 survey has shown strong growth, with their reported positions double those seen in the last survey. This growth is expected to continue in 2006, in view of the interest expressed by many of the surveyed AIs in starting, or expanding, credit derivative and securitisation activities.

With the implementation of Basel II in Hong Kong in 2007, there may also be an incentive for local banks to make more use of credit derivative and securitisation transactions, given the expanded recognition of credit risk mitigation and the more favourable capital adequacy treatment in certain securitisation transactions (such as investments in highly rated senior tranches) that will be available under the revised capital adequacy framework.

Introduction

Consistent with trends in global markets, many AIs in Hong Kong have significantly increased their credit derivative and securitisation activities in recent years as a way of transferring credit risk, managing risk concentrations, enhancing yield or improving liquidity. To facilitate its monitoring of AIs' participation in the credit derivative market, the HKMA has conducted surveys of the credit derivative activities in the banking sector since 1999. The survey became an annual exercise¹ in 2002. In 2003, the coverage of the annual survey was expanded to include securitisation transactions. The 2005 survey covered the positions of all licensed banks and restricted licence banks (RLBs) at the end of October 2005.

The survey collected details of transactions that were executed or booked in Hong Kong. It also sought information from AIs on the purpose of engaging in such transactions and future plans for the surveyed activities. New information collected in the 2005 survey included the volume of asset-backed commercial paper (ABCP) programmes² under securitisation transactions entered into by the surveyed AIs.

Major findings of the survey

The survey revealed the following major observations:

- (i) the overall level of activity in credit derivative transactions reported by the surveyed AIs almost doubled in 2005. The market continued to be dominated by foreign banks, which were predominantly engaged in trading activities;

¹ The results of the 2002, 2003 and 2004 surveys were published in feature articles in the *HKMA Quarterly Bulletin* in June 2003, June 2004 and June 2005 respectively.

² An ABCP programme is a programme under which a bankruptcy-remote special purpose entity (SPE) in a

securitisation transaction issues debt securities with (i) an original maturity of not more than one year and (ii) the payments in respect of which are secured by a pool of underlying exposures acquired from third parties and held by, or to the order of, that SPE.

- (ii) local banks' credit derivative activities increased at a much faster pace, and were more than three times higher than in 2004. Most of them took credit derivative positions to improve their yields;
- (iii) the use of long-term (over five years) credit derivative instruments has become slightly more common than that of medium-term (one to five years) credit derivative instruments;
- (iv) securitisation positions of local banks more than doubled in 2005. This was similar to the rate of increase reported by the surveyed AIs;
- (v) although residential mortgage loans remained the most popular type of underlying exposures in securitisation transactions, there was a notable shift towards securitisation transactions with credit card receivables as the underlying exposures; and
- (vi) many surveyed AIs indicated their intention to either expand or commence credit derivative and securitisation activities in the future.

Details of major findings

Total credit derivative positions

A total of 43 AIs, comprising 10 local banks and 26 branches and seven RLB subsidiaries of foreign banks, reported that they had credit derivative operations. The aggregate amount of gross positions of all surveyed AIs increased significantly to HK\$794 billion at the end of October 2005, which was 84% higher than a year before (HK\$431 billion). Table 1 provides a breakdown of the positions.

The survey revealed that market activity remained highly concentrated on a few players, with the top four AIs accounting for 95% of the aggregate gross positions. Foreign bank players, which were mainly engaged in credit derivative transactions for trading purposes, continued to dominate the market by constituting 79% of the aggregate gross positions reported.

Local banks' credit derivative activities surged in 2005, with an increase of 344% in their reported aggregate gross positions. Five of the local banks had gross credit derivative positions above 10% of their respective capital base. Apart from a few which used credit derivatives for trading purposes, most of the local banks took positions in the banking book to improve yields, mainly through the purchase of credit-linked notes.

TABLE 1

Credit derivative positions of all surveyed AIs³

(in HK\$ million)

	Buying protection		Selling protection		Total gross positions	
	2005	2004	2005	2004	2005	2004
Trading Book	404,824	212,231	362,679	188,357	767,502	400,587
Banking Book	8,615	11,747	17,876	18,807	26,491	30,555
Total	413,439	223,978	380,554	207,164	793,993	431,142

³ (i) Because of rounding, figures set out in the tables in this article may not add up.
(ii) The reported positions included those that were executed in Hong Kong but booked overseas.

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

Credit derivative positions by product

Credit default swaps remained the most common type of credit derivative instruments used by the surveyed AIs (Table 2). Total return swaps ranked second, having risen by 189% in 2005. While there was a two-fold increase in the use of credit-linked notes by local banks, these continued to drop for the other surveyed AIs.

TABLE 2

Percentage share by product type

Credit derivative products	All surveyed AIs	
	2005	2004
Credit default swap	92.6%	90.7%
Total return swap	2.8%	1.8%
Credit spread product	0.4%	2.1%
Credit-linked note	2.0%	4.6%
Others	2.2%	0.9%

Maturity of outstanding credit derivative positions

In terms of the tenor of outstanding transactions, medium-term positions (from one to five years) and long-term positions (over five years) increased substantially. Table 3 shows that as a percentage of gross credit derivative positions, the share of long-term positions rose to 51% from 35% a year ago, whereas that for medium-term positions dropped to 45% from 57%.

TABLE 3

Percentage share by maturity

Maturity of gross positions	All surveyed AIs	
	2005	2004
Within 1 year	4.4%	8.1%
From 1 to 5 years	44.7%	57.2%
Over 5 years	50.9%	34.7%

Credit derivative positions by reference entity

The distribution of reference entities of credit derivative transactions entered into by the surveyed AIs was consistent with last year, spreading over sovereigns, banks and corporates (Table 4), notwithstanding a moderate shift from sovereigns and banks to corporates.

TABLE 4

Percentage share by type of reference entity

Type of reference entity	All surveyed AIs	
	2005	2004
Central governments & central banks	29.8%	32.1%
Public sector entities	3.0%	1.3%
Banks	11.9%	15.1%
Corporates	51.2%	41.9%
Others	4.2%	9.6%

Although most of the reference entities were still located in Asia, including South Korea, Hong Kong, Mainland China and Japan, there was a notable increase in credit derivative transactions with reference entities from other countries such as those in Europe (Table 5).

TABLE 5

Percentage share by geographical location of reference entity

Geographical location of reference entity	All surveyed AIs	
	2005	2004
Hong Kong	18.3%	23.1%
Mainland China	4.8%	8.1%
Japan	3.6%	1.1%
South Korea	23.7%	31.9%
Other Asian countries	28.3%	27.3%
Others	21.3%	8.5%

Credit derivative positions by counterparty

Overseas financial institutions, covering mainly banks and securities companies, continued to be the most common type of counterparties reported by the surveyed AIs (Table 6). The level of credit risk transfer between the banking and insurance sectors remained insignificant (only about 1%).

TABLE 6

Percentage share by type of counterparty

Counterparties	All surveyed AIs	
	2005	2004
Als in Hong Kong	2.5%	2.6%
Other local non-AI financial institutions	1.0%	1.3%
<i>of which securities companies</i>	0.2%	0.1%
<i>insurance companies</i>	0.0%	0.0%
<i>others</i>	0.8%	1.2%
Overseas financial institutions	88.5%	89.0%
<i>of which banks</i>	75.2%	65.2%
<i>securities companies</i>	12.5%	23.2%
<i>insurance companies</i>	0.8%	0.6%
Others	8.2%	7.1%

Total securitisation positions

Thirty-four AIs reported participation in the securitisation market, either as investing or originating AIs, compared with 31 AIs in the previous year. Their aggregate positions amounted to HK\$91 billion, which doubled the aggregate positions recorded a year ago (Table 7).

On the whole, the surveyed AIs were more active in investing than in originating activities. About 82% of the positions were for investing purposes, compared with 74% a year ago. The number of local banks reporting securitisation positions dropped slightly to 11 from 12 a year ago, but their share in the total positions of all surveyed AIs remained at a high level of 73% (2004: 75%). The survey revealed that market activity continued to be concentrated, with

the top three AIs accounting for 69% of the total positions of the surveyed AIs.

Securitisation positions by product

Of the reported transactions, 78% were traditional securitisations, and 22% were synthetic securitisations⁵, which doubled its share from last year. Residential mortgage loans remained the most popular type of underlying exposures although their share dropped from 58% to 46%. On the other hand, the share of credit card receivables, at 11%, had more than doubled (Table 8).

TABLE 8

Percentage share by type of underlying asset

Type of underlying asset	All surveyed AIs	
	2005	2004
Claims on central governments and central banks	3.3%	0.8%
Claims on public sector entities	5.1%	7.4%
Claims on banks	1.8%	1.1%
Claims on insurance companies	0.5%	0.3%
Claims on securities companies	0.1%	0.0%
Claims on corporates	5.8%	3.6%
Residential mortgages	45.5%	58.3%
Commercial mortgages	2.3%	6.7%
Credit card receivables	11.2%	4.8%
Other personal lending	4.0%	6.5%
Car loans	3.5%	1.5%
Taxi and public light bus loans	2.8%	6.1%
Non-performing obligations	–	–
Others	14.1%	2.9%

TABLE 7

Securitisation positions of all surveyed AIs⁴

(in HK\$ million)

Form of securitisation	Originating bank		Investing bank		Total outstanding position	
	2005	2004	2005	2004	2005	2004
	Traditional	11,849	8,773	59,014	30,203	70,863
Synthetic	4,221	2,401	15,499	2,297	19,720	4,698
Total	16,070	11,174	74,513	32,501	90,583	43,674

⁴ If the originating bank and investing bank of a securitisation transaction are both surveyed AIs, the same transaction is reported under "originating bank" and "investing bank" respectively.

⁵ Synthetic securitisation refers to transactions where credit risk is transferred through the use of funded and unfunded credit derivatives or guarantees that serve to hedge the credit risk of the portfolio.

Eighty-nine percent of the securitisation positions reported in the survey were of investment grade. Of the unrated, there was no exposure under ABCP programmes. By the type of interest rate payments, nearly all synthetic securitisations and 84% of the traditional securitisations were floating interest rate transactions and the remaining 16% were fixed rate.

Future plan for credit derivative and securitisation operations

Many surveyed AIs indicated their interest in either expanding or commencing credit derivative operations in the future, mainly for hedging or taking credit exposures in the banking book. A few AIs not currently active in credit derivatives planned to commence operations in both the banking book and trading book.

Similar to credit derivative operations, many surveyed AIs indicated their interest in either expanding or starting securitisation operations in the future, as investing or originating AIs.

Conclusion

In line with the trend of the global credit risk transfer markets, the credit derivative and securitisation activities in the local banking sector are likely to continue their growth momentum in 2006. With the implementation of Basel II in Hong Kong in 2007, there may be an incentive for local banks to make more use of credit derivative and securitisation transactions given the expanded recognition of credit risk mitigation and the more favourable capital adequacy treatment for certain securitisation transactions (such as investments in highly rated senior tranches) that will be available under the revised capital adequacy framework.

In view of the emergence of new products with distinctive structures in credit derivative and securitisation transactions, the HKMA will continue to monitor developments in the credit risk transfer markets and AIs' participation in them. The aim is to ensure they have the ability to understand and manage properly the credit risk and other risks associated with the activities.