Bond market development – Need for CDS

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A vibrant corporate bond market is critical for meeting the long term financing requirements for infrastructure development & other capital-intensive investments for an economy such as India. This is especially in the context of Indian private sector which was able to access only 10% of its debt requirement through market sources compared to 22% for public sector in 2017(Source: RBI). Even within the primary issuance market, the share of manufacturing sector was less than 1% in 2017 (Source: RBI). While the corporate bond market has grown substantially in India with FY18 issuances at Rs. 6.6 lakh crs from Rs. 3.7 lakh crs in FY14 (Source: CRISIL), 85-90% of the issuance was geared towards AAA & AA leaving very less capital for the emerging businesses. Given that there are 2,400 "A" rated issuers with aggregate long term bank facilities of Rs. 10 lakh crs (Source: CRISIL), there is a significant potential for providing debt capital to such credits from investors who have high risk appetite. Lower rated bond issuances did pick up in the last 3 years & along with new IBC norms led to expectations of deepening of bond market. Mutual fund were key beneficiaries of this trend with credit fund industry AuM growing from Rs. 37,000 crs in FY14 to Rs. 1,32,000 in FY19 while 'A' rated securities held by mutual funds increasing from Rs. 9,400crs approximately in FY14 to Rs. 69,000crs in March 19 (Source : ICRA online).

However, the ongoing credit turmoil in the mutual fund space where investors were exposed to sudden & sharp rating downgrades by multiple notches to even defaults in some cases & sharp erosion in bond prices has dented investor confidence. While high yield credits undergo seasoning in line with the credit cycle, this was a negative surprise to some market participants as bond yields failed to reflect the underlying deterioration in credit quality of those issuers. Therefore, effective management of credit risk has become even more critical for financial institutions' risk management strategy to ensure that their financial health remains sound & investor confidence is enhanced. This has led to calls for tighter regulation of mutual funds, more accountability from rating agencies, restriction on investments, better disclosure from issuers etc. While some of the steps to reform the bond market are much needed, one of the primary concern of the investors that the bond prices in the high yield corporate bonds failed to reflect the change in their credit quality while fund managers failed to exit their bond positions. The main reason behind this lack of liquidity & hence price discovery in bond market.

As can be seen from the table below, AA & A rated securities tend to be very illiquid due to limited investor base. 61% of issuers rated "A or below" failed to trade even once in 6 months in market lots of Rs. 5crs while even 26% of issuers rated "AA or below" didn't trade during the same period. Hence even if a credit is deteriorating, there is a possibility that due to lack of trading in the same paper, bond investors cannot exit their position if their view on the credit changes. Even other participants are unable to assess the change in market perception of those issuers, unlike equity markets.

Liquiduty across Rating Categories

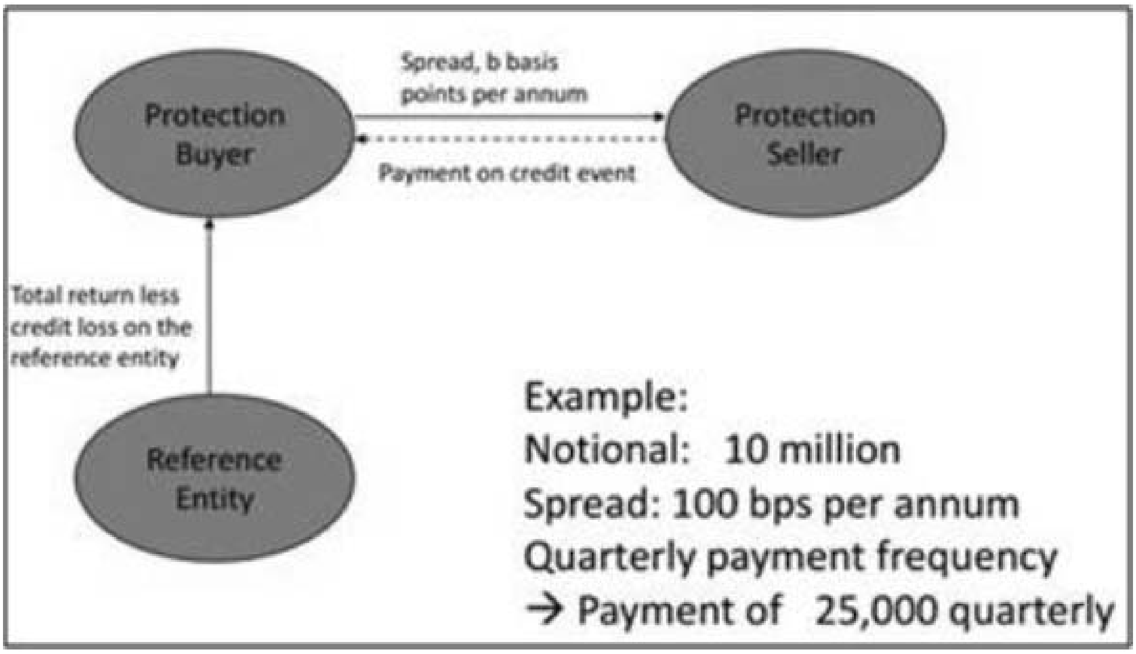
Source: CBRICS, ICRA MFI Explorer

Source for trade data is from Corporate Bond Reporting and Integrated Clearing System (CBRICS). Inter-scheme trades and trades below Rs. 5 crore have been excluded. An issuer is considered as "traded" if any one of its securities has witnessed a trade since 1st April 2018. CBRICS is not necessarily exhaustive, but is reasonably representative of primary/secondary market trades.
Data as on December 2018

Consequently, the market thus needs an instrument which can help an investor hedge his exposure in case of change in his credit view where liquidity is not available while also providing important information to other market participants like change in market risk appetite, credit spreads, default probability, etc. This is where an instrument like Credit default swap (CDS) can fill the much needed gap.

A credit default swap is essentially a bilateral contract in which a buyer agrees to pay a periodic fee - a "premium" and/or an upfront payment in exchange for a payment by the seller in the case of a credit event (such as a bankruptcy) affecting a reference entity or a portfolio of reference entities such as a CDS index. The market price of the premium is therefore an indication of the perceived risk related to the reference entity even if the actual event of default might never occur. The change in premium signifies the change in market perception of the reference entity. In case the premium is rising, it means that the risk perception of the issuer is increasing & vice-versa. Because the marketplace recognizes such events as related to one's credit worthiness, credit events can trigger specific protections provided by credit derivatives. There are several standard credit events which are typically referred to in credit derivative transactions (Source: FIMMDA):

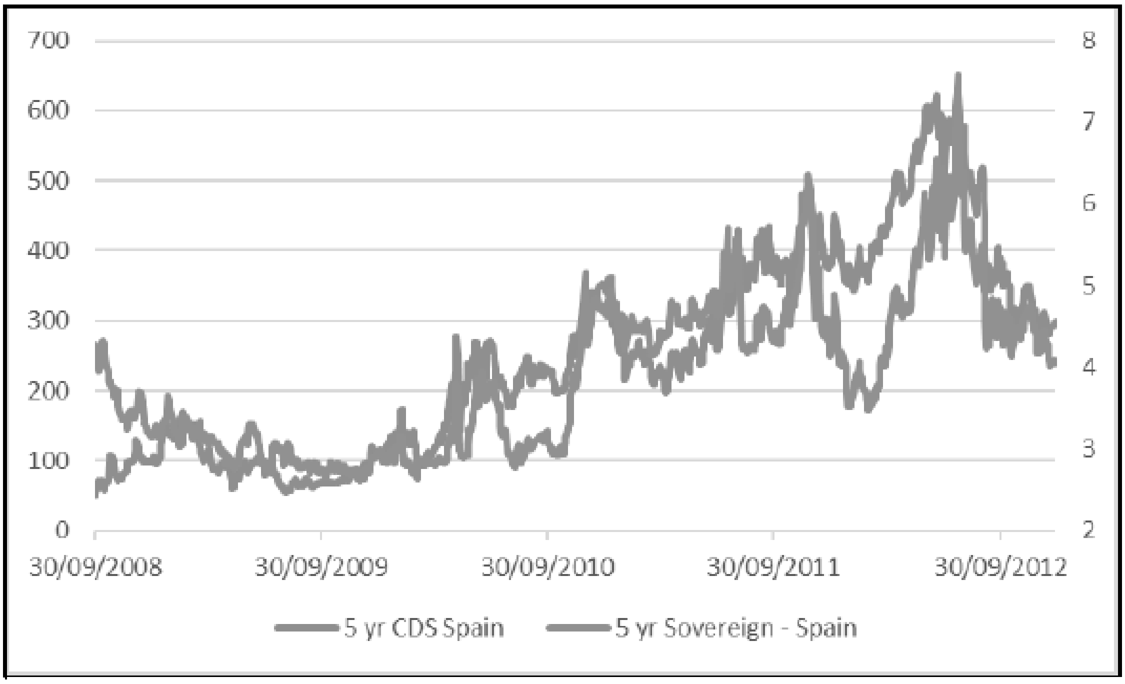
- Bankruptcy
- Failure to Pay
- Restructuring
- Moratorium
- Obligation Acceleration
- Obligation Default

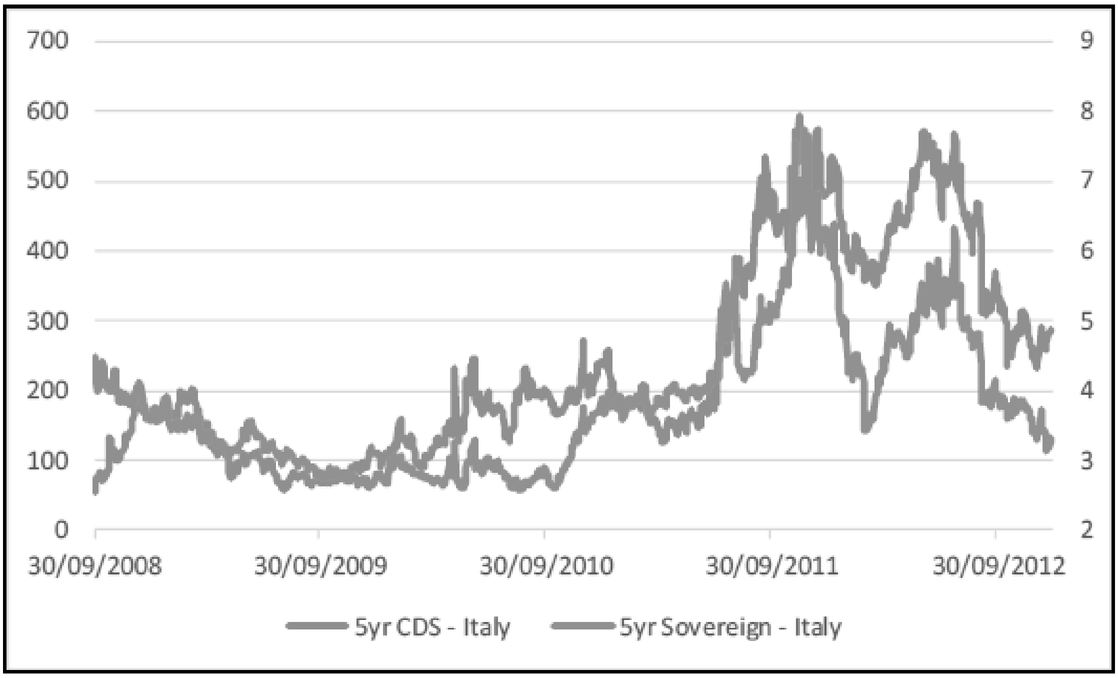


Source: FIMMDA

Hence, a CDS contract allows a counterpart to acquire long exposure to credit assets in an unfunded form when selling CDS protection while the acquirer of CDS protection is able to effectively short the underlying reference issuer. A CDS contract allows for pricing of risk that might otherwise be difficult due to lack of liquidity in the underlying assets. CDS thereby can provide a useful hedge to offset credit risk and can thereby enhance financial stability. Moreover, unlike corporate bonds, which differ substantially in coupons, maturities & features, a CDS is relatively standardized. In terms of their performance as market indicators relative to bond spreads, CDS tends to adjust rapidly to new information during periods of stress.

Does CDS capture the underlying credit quality: - Cross Country Comparison

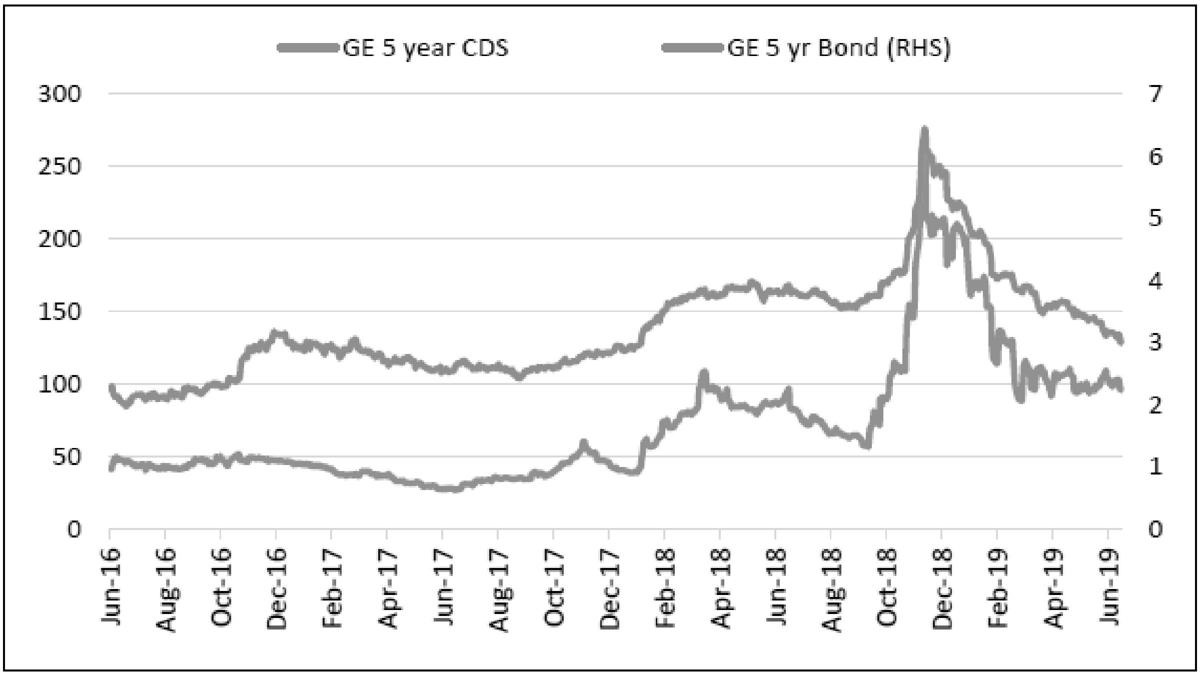




Source: Bloomberg

The charts (above) reflect the 5yr CDS premia & 5 year sovereign Italian & Spanish bond yields during the period of 2008-2012. This was the period of global financial crisis & then Eurozone peripheral crisis where the spreads between core Eurozone (Germany, France, Austria) & periphery countries (Portugal, Ireland, Italy, Greece, Spain) widened significantly due to unsustainable fiscal position of these 234567890100200300400500600700030/09/200830/09/200930/09/201030/09/201130/09/20125yr CDS - Italy5yr Sovereign - Italy countries. As can be seen above, CDS premium which signifies the credit risk of those papers moved in line with the bond yields. As 5 year Spanish bond yields moved from 2.7% in March 2010 to 4% in June 2010, Spanish 5 year CDS also moved from 100bps to 250bps & all the way to 626bps as 5 year Spanish yield climbed to 7.6% at the height of Eurozone crisis. As yields normalized after ECB's "Whatever it takes" pledge to preserve the Euro in July 2012 with 5 year Spanish yields falling to 4% by end of 2012, 5 year CDS also climbed down to 300bps. Similar behavior was observed in Italian bonds.

In case of Corporate Bonds
Following is the chart of comparison between 5 yr bond of General Electric Ltd (US) & 5 year CDS for the same. As can be seen, the CDS premium of the bond & bond yields tend to move in tandem. While investors can exit their positions in case of liquid positions in case of change in risk perception, a CDS would be extremely useful in case an investor wants to exit/hedge an illiquid credit position.



Source: Bloomberg

Reason for lackluster CDS market in India
While there have been numerous attempts by the regulators in the past to kick start the CDS market, it has not really taken off due to multiple concerns from potential CDS sellers such as banks, NBFCs etc. The lack of empirical data & evolving bankruptcy laws constrains assigning a terminal value on the credit & pricing of CDS premium. Report of the Working Group on Development of Corporate Bond Market in India submitted to RBI in 2016 also highlighted that there is also restriction on netting of MTM position against the same counterparty for capital adequacy and exposure norms. “Without netting, the trades in CDS can become highly capital intensive as banks and PDs have to provide higher capital charge on gross basis even if they are acting as market makers and having positive and negative position against the same counterparty”. Netting has not been allowed by RBI due to lack of legal clarity. The committee recommended that in order to encourage participation in CDS, “netting of MTM position against the same counterparty for capital adequacy and exposure norms have to be enabled and legal impediments may be addressed quickly. While, RBI has proposed margining for non-centrally cleared derivatives on a transaction-by-transaction basis rather than across the whole portfolio on net basis, this increases the cost of transactions and discourage market participants from trading. Pending amendments to RBI Act, based on expert legal opinion, the committee recommended possibility of permitting “netting” keeping in view the existing legal provisions and banking practices”. We believe once Bankruptcy laws under IBC also evolve & market participants are more confident on Loss Given defaults & timeframe of credit resolution process, Indian market should develop better valuation methodology, more active participants & higher volumes & hence aid in much needed development of lower rated corporate bonds.

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