

DERIVATIVES

Warrants on the rise

By Timothy Cuffe, | 29 November 2006

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FinanceAsia speaks to Citigroup's head of Asia-Pacific warrants, Michael Walker, about the growth of Asia's warrants markets.

What major trends are you seeing in Asia's warrants markets?

I think we are seeing strong growth in the warrants markets regionally, the major warrants markets being Hong Kong, Singapore and Korea and to a lesser extent, because it is a company-listed warrants market, China.

Although Shanghai has shown extraordinary growth, the warrants listed on that exchange are company-issued warrants as opposed to bank-issued warrants that we see in other developing warrants markets in Asia.

Growth has continued to be strong. Up until the end of September, the Hong Kong stock exchange turnover was in excess of \$153 billion, surpassing last year's turnover of \$110 billion. Essentially that makes Hong Kong the second biggest warrants market globally behind Germany's Deutsche Bourse.

As I said, Shanghai has seen extraordinary growth but it is only company-listed warrants. However up until the end of September, turnover on the Shanghai Stock Exchange has been something in the order of \$129 billion. This is a marked increase over last year which saw only \$21.5 billion in turnover.

Korea is a very exciting market. It only started in December 2005, and has a year to date turnover of \$29.4 billion, making it one of the top five global warrants markets. That puts it well ahead of Australia and Switzerland, which are 10-year-old developed markets.

Korea has gone from being less than \$50 million turnover per day to in excess of \$200 million in daily turnover. It has been the fastest growing warrants markets in the world. With the number of listings having grown from 70 new issues per month in December of last year to 247 in August, there has been a tremendous amount of progression.

Additionally, there has been a constant trend in terms of growth in the percentage of turnover that warrants make up on the Korean exchange. At its peak in August it got up to 16%, although September saw that decline to around 11% to 12%. Still that is a substantial portion of total daily turnover after only nine months.

In contrast, the HKEX warrant market has been averaging between 15% and low 20s of daily market turnover over the past 12 months. However that proportion shot up to around 30%, in the last month, which I attribute mainly to the popularity of warrants over the recent listings of the China bank shares. For this reason, the HKEX and SGX have been quick to respond to investor demand now allowing warrants to be listed in their respective exchanges to coincide with the listing date of the IPO.

Why have the markets evolved so quickly?

Korea is one of the most active markets in the world when it comes to retail participation in the stock market,

futures and futures options markets. So there is a very sophisticated retail marketplace, and that has contributed significantly to the success of the warrant market over such a short period of time.

The Korean futures and options market is the most active globally. So moving from the futures and futures options over the index into warrants, which are just options over stocks, is an easy transition for the retail player in Korea.

The emergence of the warrants market has given the Korean retail investor access to a leverage product that they didn't have access to prior. Historically, retail and institutional investors have played the index options but getting access to options over single stock names in Korea was difficult because the exchange traded option market is not very liquid. But with the opening up of the warrants market, they now have a tool giving them easy access to options over single stocks, which means they can now access the blue chip Korean stocks, but via the warrants market and get the general benefits out of using warrants, like low premium upfront, access to leverage and easily traded through a standard share brokerage account without the need for margins or collateral.

Hong Kong has grown significantly from 2002 to 2005 after changes to the listing rules in 2002 reinvigorated the Hong Kong warrants market. The Hong Kong warrants market all but died in 2002 as the regulatory uncertainty saw the number of warrants on issue dwindle, but regulatory reforms by the SFC resulted in changes which included the relaxation of minimum placement requirements and the introduction of Liquidity Providers.

The Hong Kong warrants market was fairly active prior to 2000, but it was very difficult to operate because the rules were quite restrictive for warrant issuers. The HKEX worked with the product issuers and the SFC to overhaul the rules and regulations by looking at what was being done in other markets like Australia which had been growing at a very fast rate. These changes helped to create a market that has a wider universe of warrants with different terms for investors to choose from, greater transparency and liquidity.

Who is buying structured products and how sophisticated are Asian retail clients? Is their knowledge of warrants superior to that of European or Australian investors?

In Asia, the level of sophistication is high, and it is growing. This growth can be attributed to the issuers who are making sure that they are educating the investing public and the brokers as to how to use the warrants; what the risks are; and how they work. I think that is a good practice that has been lifted from Europe. Citigroup was a pioneer in the warrant sector and has always been a leading player in the development and education of the global marketplace.

This practice originated in Germany, the world's biggest warrants market, where Citigroup together with some other European houses created the formula for developing the warrants markets that you have seen evolve in Asia - a focus on investor education; on providing investors access to product specialists - we saw this successfully deployed in Australia and we are now bringing those best practices here to Asia.

How do the markets differ in terms of themes by jurisdiction?

There are some interesting themes taking place in the Asian marketplace. Looking at Korea, it is probably the heaviest in terms of online trading, which accounts for around 85% to 90% of retail market participation - a much larger portion than you would see in any other market.

The Kospi index warrants account for about 25% of the listed warrants but account for over 60% of the total warrants turnover. This is not unusual for index warrants to account for a substantial proportion of the daily turnover, it happens in Hong Kong, as well, but not to such a large extent.

Another aspect that has struck me as unusual about Korea is the relative popularity of the index warrants over single stock warrants. Given that the futures and futures options markets are so liquid, very active and have large retail participation in contrast to the single stock option market, which has no liquidity and doesn't really trade. Surprisingly Index warrants are the most popular underlying for warrants in the market.

In terms of Hong Kong, it is one market where we see significant turnover in the market. It is a market where on a particularly busy day, taking for example the recent listing of China Merchants Bank warrants; it is not unusual to see the complete issue size of the warrants get turned over. That is quite an unusual aspect of the Hong Kong market that is just not seen in any other market around the world.

What impact do structured products have on the regional stock markets where they are used?

While theoretically, the market impact looks and sounds large in terms of warrant hedging, the presence of all of the structured products in the market dampen the overall impact of what that hedging might have. The effect is not as significant as some might estimate. While the issuers in terms of their pure warrant positions might have to adjust their hedge by a significant amount most of the issuers in the market also have active structured products businesses and they have trades on structured products and products on the other side offsetting the impact of that warrant hedging.

So in theory the market impact could be significant if you calculate it on an underlying share basis just for warrant positions outstanding, while in actual fact, if you look at the market as a whole there is also a vast array of products outstanding in the market and the risk management dynamics of those products, substantially offset the individual product hedging requirements.

Citigroup has only recently begun to expand its Asian warrants business, what is the catalyst to doing it now?

I moved up in May to establish the regional warrants businesses, and we have been in the process of building up the regional teams. We have a Hong Kong team and we have a Korean team. We currently cover Singapore, but we will begin to focus on Singapore as an individual market next year.

While we are a relatively new entrant to the Asia Pacific warrant markets, Citigroup has a lot of experience in warrants globally. Many people in Asia do not realize that Citigroup has a long history in warrants, particularly in Europe, Citibank issued the first ever warrants in 1986 and was the first to set up a real-time electronic trading platform for its warrants.

We have had a lot of success in Europe and Australia and we are confident that we can take that experience and success and bring it to Asia.

What are your expectations in terms of growth of the Asian warrants marketplace?

I think we are going to see ongoing growth in the market, particularly if we continue to see strong equity markets. Given that volatility in equity market is generally lower than its historical norm, you are not getting the significant shock to the market from macro economic events; this means investors have a natural appetite for leverage which warrants provide.

Hong Kong is still growing and if the trend of China H-shares listing continues you will continue to see sustained growth. Investors are always looking for ways to access the market, and warrants give them an easy way to access the market without having to outlay a lot of capital, it gives them some leveraged exposure to the underlying share and they know the maximum risk up-front which is limited to the amount that they outlay unlike other derivatives.

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