RBI Guidelines on Credit Default Swaps in India

In legal terms, a Credit Default Swap (hereinafter, CDS) is a bilateral contract, where the rights and obligations of the parties arise from the credit risk of a reference entity or asset[1]. It is a promise by one party, the protection seller, to pay another party, the protection buyer, in case of the occurrence of a credit event (as defined in the contract). Common credit events include default and declaration of bankruptcy by the reference entity, debt restructuring, and downgrade of credit rating[2]. Thus, the risk of third party default is shifted from the protection buyer to the protection seller. In return for this shift, the protection buyer makes periodic payments to the protection seller – the premium being directly proportional to the perceived risk of default. The protection seller, on his part, must pay the protection buyer in case the underlying reference entity experiences a credit event[3].Often, CDS also require the protection seller to provide collateral for its obligation under the contract[4] . It must be noted that CDS are synthetically created in that there is no actual transfer of assets, unlike in a securitisation.[5]

In case of a default, there can be either a physical settlement or a cash settlement of CDS. In a physical settlement, the reference assets are transferred to the protection seller by the protection buyer, who in turn makes a payment equivalent to the par value of the reference asset to the protection buyer. In case of a cash settlement, the amount payable by the protection seller to the protection buyer will be equivalent to the notional amount of the CDS after deducting the market value of the reference assets after default.[6]

Applications of CDS

The most obvious use of CDS is as a tool to hedge against the credit risk of on-balance sheet assets. Protection buyers use CDS to insure themselves against any default or downgrade on the bonds they own.13 By allowing for this, CDS redistribute risk of loss that a creditor is faced with on entry into a

---

[1] Joanne, P. Braithwaite, The Inherent Limits of ―Legal Devices‖: Lessons for the Public Sector's Central Counterparty Prescription for the OTC Derivatives Markets, 12(1) European Business Organization Law Review 87, 92 (2011)

[2] Stefano Giglio, Credit Default Swap Spreads and Systemic Financial Risk, available at http://www.greta.it/credit/credit2011/PAPERS/Speakers/Friday_30/1_Giglio.pdf (Last visited: 12/11/2012).

[3] Ibid.

[4] Robert S.Bloink, Does the Wall Street Reform Act Rein in Credit Default Swaps? An EU Comparative Analysis, 89 Neb. L. Rev. 587, 595 (2011).

[5] Ibid.

[6] Ibid. p. 595

debt investment among the creditor and the CDS counterparty. Therefore, if a borrower defaults and a creditor has entered into a CDS, the creditor is not as susceptible to the risk of loss as he was without the CDS.

Importance of CDS to Emerging markets

Notwithstanding the fact that CDS as a product had its repercussion's in increasing the financial complexity of the market, the authors of this work are of the humble opinion that Credit Default Swap can be of prominent help to emerging economies primarily on account of following points:

1. Credit Default Swap (CDS) can help market participants a tool to transfer and manage credit risk in an effective manner through redistribution of risk.

2. Specially funding of SMEs (Small and Medium Enterprise) may be supported by credit derivatives, a systematic structure can be formed in the following manner: Banks can transfer the credit risk to a third party, which in turn can transfer that risk to a pool of investors, since the credit risk would not remain primary concern of the banks, banks might be willing to infuse more funds in the SME sector. The investors will also be benefitted as new asset class would be available to them,which can be incorporated as a part of their portfolio.

3. Credit Default Swap will have benefits like enhancing investment and borrowing opportunities and reducing transaction costs while allowing risk-transfers

4. Such products would also increase investors' interest in corporate bonds and would be beneficial to the development of the corporate bond market in a country like India.

5. Another important advantage is that, it would act as an alternate way of taking short position on a reference entity/ obligation. For Example, an investor wishes to take short position on bonds of company XYZ, but is not being able to take that position due to lack of liquidity in the market. In such scenario, he can take a long position on CDS on XYZ's bond. Thus CDS would provide an effective way to trade on credit risk to market participants

The key features of the RBI guidelines on CDS are as follows

• Participants in the CDS market are classified as either Users or market makers.User Entities are permitted to buy credit protection (buy CDS contracts) only to hedge their underlying credit risk on corporate bonds. Such entities are not permitted to hold credit protection without having eligible

underlying as a hedged item (clause 2.1).The users cannot buy CDS for amounts higher than the face value of corporate bonds. This is the most important point of difference, as there was no such limitation in United States of America prior to 2008, and hence many Institutional players had taken huge long positions (in CDS) without having any exposure to reference asset.

• Since the users are envisaged to use the CDS only for hedging their credit risks, assumed due to their investment in corporate bonds, they shall not, at any point of time, maintain naked CDS protection i.e. CDS purchase position without having an eligible underlying bonds held by them and for periods longer than the tenor of corporate bonds held by them.(clause 2.5.2).

• The eligible entities under user's category would be Commercial Banks, PDs, NBFCs, Mutual Funds, Insurance Companies, Housing Finance Companies, Provident Funds, Listed Corporates, Foreign Institutional Investors (FIIs) and any other institution specifically permitted by the Reserve Bank of India.(clause 2.1.1)

• CDS will be allowed only on listed corporate bonds as reference obligations. However, CDS can also be written on unlisted but rated bonds of infrastructure companies. [clause 2.4 (I) & (II)].This is another major area of difference between the US markets and RBI guidelines. In United States of America, the CDS were written on various pass through securities like Mortgage Backed Security(MBS), Collateralized Debt Obligation (CDO) etc, whereas as per the RBI guidelines, the CDS are specifically restricted for listed corporate bonds, the obvious reason being that there is no big market of pass through securities in India as it is in US.

• The credit events specified in the CDS contract may cover: Bankruptcy, Failure to pay, Repudiation/moratorium, Obligation acceleration, Obligation default, Restructuring approved under Board for Industrial and Financial Reconstruction (BIFR) and Corporate Debt Restructuring (CDR) mechanism and corporate bond restructuring.(clause 2.11.1).

• Since, CDS are traded mainly over-the-counter (OTC), the contracting parties therefore have to agree upon the terms and conditions of the CDS individually – such as definitions Prof. Utkarsh Jain & Prof. Kaustubh Medhekar 50 Volume III September 2011 SIBM 51 Volume III September 2011 SIBM of the credit events or settlement procedures. In order to facilitate documentation, and to avoid disputes as to whether a credit event had actually occurred and how a contract should best be settled, CDS contracting parties (in the international and US market) generally refer to the International Swaps and Derivatives Association (ISDA) Master Agreement. In India, the RBI guidelines specifically states

that Fixed Income Money Market and Derivatives Association of India (FIMMDA) shall devise a Master Agreement for Indian CDS (clause 2.9)

• Regarding the Settlement procedures, the RBI Guideline states that the parties to the CDS transaction shall determine upfront, the procedure and method of settlement (cash/physical/auction) to be followed in the event of occurrence of a credit event and document the same in the CDS documentation. (Clause 2.12.1). However it further adds that for transactions involving users, physical settlement is mandatory(Clause 2.12.2). For all other transactions, market-makers have been permitted to opt for any of the three settlement methods (physical, cash and auction), provided the CDS documentation envisages such settlement (Clause 2.12.2).

• Further, The guidelines specifically provide norms for Prevention of mis-selling and market abuse, wherein it requires protection sellers to ensure that CDS transactions shall be undertaken only on obtaining from the counterparty, a copy of a resolution passed by their Board of Directors, authorizing the counterparty to transact in CDS. (clause 3.10)

• RBI has also incorporated certain reporting requirements in the guidelines which would require market makers to report their CDS trades with both users and other marketmakers on the reporting platform of CDS trade repository within 30 minutes from the deal time(clause 4.1.1). The users would be required to affirm or reject their trade already reported by the market- maker by the end of the day(clause 4.1.2). In addition to these reporting requirements the participants are also required to report to respective regulators (e.g. IRDA for Insurance companies) information as required by them such as risk positions of the participants vis-à-vis their networth and adherence to risk limits, etc.