RBI Guidelines on Credit Default Swaps for Corporate Bonds

Please find below comments on CDS market and a summary of Guidelines issued by RBI on 23 May 2011

RBI has released final guidelines for Credit Default Swaps in corporate bonds. The rupee denominated CDS market is likely to kick off as soon as the guidelines become effective from 24th October 2011. The responses by the bond market participants to introduction of CDS are that of eagerness as opposed to the reluctance with which the interest rate futures were received. The market participants had clearly questioned the success of interest rate futures, owing to the complicated design of the product, and their concerns were proved to be legitimate, as we see, the IRF market is now almost defunct.

CDS in itself is not a simple product but given the fact that structured derivative products are more likely to succeed in the OTC market (as opposed to exchange traded products), the odds are for success of CDS in Indian financial markets. In this regard, CDS is most likely to follow the path of interest rate swaps market.

CDS – Global Perspective

In the global financial markets especially the G-10 markets (US, Euro zone, UK, Japan & Canada) the CDS market was the fastest growing derivatives market before the sub-prime crisis. However during the recent crisis in global markets (2007-09) the CDS market was blamed for the financial turmoil, in particular, for the near bankruptcy of the leading insurance group AIG Inc. and consequent increase in credit spreads and margin requirement affecting the investment banks. The outstanding notional of the CDS trades worldwide was seen to be much higher than the actual underlying corporate debt and the high leverage was direct cause of collapse of CDS market. RBI guidelines therefore attempt to minimize the risk of speculative trading in Indian CDS.

Some of the notable features of the CDS product traded globally are:

- The bulk CDS products which are traded worldwide are single entity CDS i.e a CDS on corporate underlyings like IBM, Wells Fargo & Co, Merrill Lynch & Co, Volkswagen AG, Daimler AG, Mitsubishi UFJ Financial etc. The single entity CDS trades on sovereign debts like Kingdom of Spain, Federative Republic of Brazil, Hellenic Republic (Greece), Czech Republic, Emirate of Abu Dhabi etc are also very common.
- Apart from the single entity exposures, CDS on indexes are also widely traded. Some of the prominent CDS indices are MarkIt Itraxx and CDX. The credit default swaptions market is also active on the CDS index underlyings.
- The CDS indexes market is active for both Investment Grade issuances as well as High Yield (Junk grade) issuances.

- CDS market for other illiquid underlyings like loans; mortgages like ABS, MBS, pools & TBAs (To Be Announced) also exists.
- All the major investment banks like Goldman, Deutsche, JP Morgan, Barclays, BNP Paribas etc are market makers in the CDS market. The investor/ trader segments include most of the financial entities like hedge funds, commercial banks, pension funds, mutual funds, mortgage houses, insurance companies etc.
- MarkIt is the leading provider for the data on CDS markets and the widely used valuation model for CDS is the JP Morgan model.

Despite the criticism faced by the CDS worldwide, it is still reckoned as one of the key financial innovations which can be used wisely to transfer credit risk. Primary objective of RBI for introducing the CDS in the Indian market is to provide market participants a tool to transfer and manage credit risk in an effective manner through redistribution of risk. At the same time RBI has taken precautions to avoid excessive use of CDS only to derive trading profits.

CDS-The India Story

USD denominated CDS market on Indian entities is already active in the financial markets of countries like US, UK and Singapore. Few of the prominent Indian CDS entities are ICICI, Tisco, Reliance Industries, Exim Bank & IDBI bank. Indian entities are also a part of the CDS indexes market, being a component of MarkIt Itraxx index like 'MarkIt Itraxx Asia Ex-Japan'. A lot of equity market participants do track the movements in the CDS spreads of these Indian entities.

RBI had earlier published the CDS draft guidelines in 2007 and was looking forward to introduce the CDS in Indian markets the following year. However the decision was held back as the global financial markets were hit by a severe recession which also led to a major credit crunch. Credit derivatives market faced severe criticism by various sections like financial market regulators, academicians, market participants and most importantly by political leaders in the developed countries. The world then witnessed a series of events like bankruptcy of Lehman Brothers; sell off of Merrill Lynch and bailout packages handed out to leading banks like Citigroup, Goldman Sachs, Bank of America and AIG.

One of the key intentions of RBI in introducing the CDS in India is to develop the underlying corporate bond markets, especially that of the infrastructure financing. By introducing the CDS the RBI wants to develop an avenue wherein the infrastructure financiers can transfer the risk. Currently the secondary corporate bond market lacks depth with an average daily traded volume of around Rs.200 cr as against annual primary market issuance of around Rs.1.60 lakh crores. Investors (mostly banks, pension funds and insurance companies) being highly risk-sensitive, the secondary market for issuances rated below AA is non-existent. The issues like stamp duty and long shut periods (record dates during book closures in which bonds aren't traded) have plagued the corporate bond market since a longtime.

Other RBI measures to promote debt market include permitting Repo in corporate bonds and interest rate futures. For various reasons both the measures failed to bring in momentum to the debt market. Let us hope that CDS would provide required comfort to potential investors.

RBI's CDS Guidelines

- RBI has allowed the FIIs to trade in the CDS market which is a good move in order to ensure the success of the market. It also necessary as recently RBI has hiked the FII limit in corporate bonds by USD20 bn and the FIIs are eager to get a slice of the Indian debt market. Presence of credit risk hedging option would encourage FII interest in corporate bonds further.
- RBI has permitted commercial banks, PDs, Mutual Funds, Insurance Cos, Housing Finance Cos, PFs and listed corporates and thus ensured that all the debt market participants are given an opportunity to hedge their credit risk.
- RBI after consultation with the state run banks amended the earlier requirement for market maker wherein the minimum capital to risk weighted assets ratio was relaxed by 1% to 11% and also the core Tier 1 CRAR was relaxed by 1% to 7%.
- In response to the global criticism of CDS the RBI has made sure not to permit CDS on illiquid underlyings like ABS, MBS, convertible bonds etc. CDS is also not allowed to be part of any other structured offering.
- It is expected that FIMMDA would set market standards for CDS valuation and would also, as directed by the RBI, publish the CDS spreads curve. FIMMDA & RBI need to pay more attention to this area as the CDS valuation is very complex; with kind of spreads/ default probabilities to be used and the recovery rates to be used, lien/ seniority of the underlying bond etc.

Overall we would say that the introduction of CDS is a positive step for development of financial markets in India. While establishing prudential practices, RBI should also allow flexibility in the guidelines in case the product is initially slow in picking up. This is very likely as the underlying corporate bond market is not very vibrant and market players need time to appreciate the benefits of CDS.

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WHERE RISK MEETS ITS MATCH

Summary of Guidelines on Credit Default Swaps (CDS) for Corporate Bonds, effective from October 24, 2011

Eligible Participants	Users : 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. Market Makers : Commercial Banks, stand alone Primary Dealers (PDs), Non-Banking Financial Companies (NBFCs) having sound financials and good track record in providing credit facilities and any other institution specifically permitted by the Reserve Bank.
Users	(a) Buyers of credit protection only to hedge their underlying credit risk on corporate bonds hence user's should have eligible underlying . (b) Users are not allowed to sell protection and are not permitted to hold net short positions in the CDS contracts. (c) The users cannot buy CDS for amounts higher than the face value of corporate bonds held by them and for periods longer than the tenor of corporate bonds held by them.
Market Makers	(a) are permitted to quote both buy and/or sell CDS spreads, and (b) permitted to buy protection without having the underlying bond.
Eligibility norms for market-makers :	
I. Commercial Banks	a) Minimum CRAR of 11 per cent with core CRAR (Tier I) of at least 7 per cent; b) Net NPAs of less than 3 per cent.
II. NBFC's	a) Minimum Net Owned Funds of Rs. 500 crore; b) Minimum CRAR of 15 per cent; c) Net NPAs of less than 3 per cent; and d) Have robust risk management systems in place to deal with various risks.
III. PDs	PDs intending to act as market-makers shall fulfil the following criteria:

	a) Minimum Net Owned Funds of Rs. 500 crore; b) Minimum CRAR of 15 per cent; and c) Have robust risk management systems in place to deal with various risks.
Reference Entity	(a) The reference entity in a CDS contract, against whose default the protection is bought and sold, (b) shall be a single legal resident entity and direct obligor for the reference asset/obligation and the deliverable asset/obligation.
Reference obligation	The reference obligations are required to be in dematerialised form only CDS will be allowed only : (a) listed corporate bonds as reference obligations (b) on unlisted but rated bonds of infrastructure companies. (c) Unlisted/unrated bonds issued by the SPVs set up by infrastructure companies are also eligible as reference obligation. Such SPVs need to make disclosures on the structure, usage, purpose and performance of SPVs in their financial statements.
Exiting CDS transactions by users	(a) Users cannot exit their bought positions by entering into an offsetting sale contract. (b) They can exit their bought position by either unwinding the contract with the original counterparty or, in the event of sale of the underlying bond, by assigning (novating) the CDS protection, to the purchaser of the underlying bond (the "transferee") subject to consent of the original protection seller (the "remaining party"). (c) In case of sale of the underlying, Users will have a grace period of 10 business days from the sale of the underlying bond to unwind the CDS position.
Other Requirements	a) the reference asset/obligation and the deliverable asset/obligation shall be to a resident and denominated in Indian Rupees; b) the CDS contract shall be denominated and settled in Indian Rupees; c) Obligations such as asset-backed securities/mortgage-backed securities, convertible bonds and bonds with call/put options shall not be permitted as reference and deliverable obligations; d) CDS cannot be written on interest receivables; e) CDS shall not be written on securities with original maturity up to one year e.g., Commercial Papers (CPs), Certificate of Deposits (CDs) and Non-Convertible Debentures (NCDs) with original maturity up to one year;

	f) the CDS contract must represent a direct claim on the protection seller. g) dealing in any structured financial product with CDS as one of the components shall not be permitted; and h) dealing in any derivative product where the CDS itself is an underlying shall not be permissible. i) It needs to be ensured that CDS are not used to build up excessive leveraged exposures.
Documentation	Master Document is to be devised by FIMMDA. There would be two sets of documentation: one set covering transactions between user and market-maker and the other set covering transactions between two market-makers.
Credit Events	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.
Settlement Methodologies	(a) For transactions involving users, physical settlement is mandatory. (b) For other transactions, market-makers can opt for any of the three settlement methods (physical, cash and auction), provided the CDS documentation envisages such settlement. (c) If parties do not select Auction Settlement, they will need to bilaterally settle their trades in accordance with the Settlement Method (unless otherwise freshly negotiated between the parties).
Accounting	(a) CDS contracts shall be on the lines indicated in the 'Accounting Standard AS-30 – Financial Instruments: Recognition and Measurement', 'AS- 31, Financial Instruments: Presentation' and 'AS-32 on Disclosures' as approved by the Institute of Chartered Accountants of India (ICAI). (b) market participants, with the approval of their respective boards, shall adopt appropriate norms for accounting of CDS transactions which are in compliance with the Indian accounting standards and approved by the regulators from time to time
Pricing/Valuation methodologies for CDS	(a) marking to market the CDS contracts on a daily basis. These methodologies should be validated by external validators periodically for reliability. (b) Market participants shall use FIMMDA published daily CDS curve to value their CDS positions. (c) Day count convention may also be decided by FIMMDA in consultation with market participants.

	(d) if a proprietary model results in a more conservative valuation, the market participant can use that proprietary model.
Risk Management, Cash Margin and Reporting requirements	Please see detailed guidelines in the RBI circular of 23 May 2011