

A primer on Credit Default Swap (CDS) & RBI guidelines on CDS

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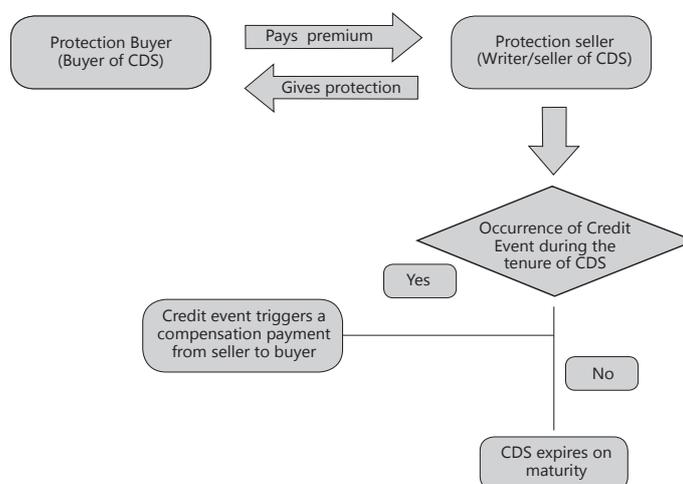
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Reserve Bank of India through a notification (RBI/2010-11542 IDMD.PCD.No.5053/14.03.04/2010-11) issued guidelines on Credit Default Swaps (CDS) for corporate bonds in India. The market has given a mixed response, primarily due to apprehension and misconceptions about the said product. There has been much confusion in public debate about the role CDSs played during the crisis in United States. In this light the study tries to analyze the mechanics of the CDS, the relation of CDS and late 2000s financial crisis, the importance of CDS to Emerging markets, the present scenario in India and a commentary on recent RBI Guidelines on CDS.

What are CDS?

A (single name) credit default swap (CDS) allows the contracting partners to trade or hedge the risk that an underlying entity defaults – either a corporate or a sovereign borrower. There are two sides entering into the contract: The protection buyer pays a yearly premium until a pre-defined credit event occurs or until the contract matures. In return, the protection seller assumes the financial loss in case the underlying security defaults or the reference borrower



becomes insolvent. In effect, a CDS contract resembles an insurance policy, where one side assumes the risk and the other pays an (insurance) premium. When entering the contract, protection buyer and seller agree upon a premium, which compensates the protection seller for bearing the risk of a default.^{1,2}

Since credit default swaps are presently not traded on any of the organized exchanges, they are a part of the over-the-counter (OTC) derivatives market in various European and American markets. Though still a relatively small part of the huge market for OTC derivatives, credit derivatives are growing faster than any other OTC derivative.³

In addition to the CDS "spot market" there is also a market for options and forwards written on CDSs. Options on CDSs, so called Credit Swaptions, give the buyer the right but not the obligation to receive or sell protection for a predetermined premium, whereas CDS forwards oblige the parties to buy or sell CDS protection in future at a certain price.

CDS & The late 2000s financial Crisis

Many causes for the financial crisis have been suggested, with varying weight assigned by experts, the United States Senate issuing the Levin–Coburn Report found "that the crisis was not a natural disaster, but the result of high risk, complex Financial products; undisclosed conflicts of interest; and the failure of regulators, the credit rating agencies, and the market itself to rein in the excesses of Wall Street."⁴

The 2008 crisis revealed several shortcomings in CDS market practices and structure in United States. Lack of information on the whereabouts of open positions as well as on the extent of economic risk borne by the financial sector is partly to blame for the heavy reactions observed during the crisis. In addition, management of counterparty risk has proved insufficient, as has in some instances the settlement of contracts following a credit event.⁵

The Credit Default Swap market was largely unregulated in United States. Huge amount of exposure was taken by various institutional players, without having corresponding exposure to reference asset. At the risk of stating the obvious, the primary motive of taking such huge positions in CDS compared to the exposure to the reference asset was speculation and not hedging. Since, the regulatory framework and reporting mechanisms were not stringent; there were almost no disclosures of the positions taken in the market by the players.

According to Deutsche bank report published in December 2009, at the peak of use of CDS instruments (pre 2008 crisis), gross notional amounts outstanding had reached an impressive USD 58 trillion (June 2007, BIS data), which compares to a notional value of debt securities outstanding worldwide of USD 80 trillion at the time. The issue of interconnect-edness and, hence, the potential for contagion played a role in the decision to grant public assistance to AIG. Prior to the crisis AIG had accumulated considerable CDS positions in both gross and net terms that threatened to drag down other institutions.⁶

The report further adds that, the collapse of Lehman finally confronted market participants and supervisors with the failure of a relevant CDS counterparty that was also an important reference entity. Market reactions were heavy, owing to the fuzziness of information on actual

credit exposures in a market where trading takes place over-the-counter (OTC). Skimming through it the fallout became soon clear that CDS net exposure referenced to Lehman was a mere fraction of the total amount outstanding, and that potential losses linked to Lehman as a reference entity had largely been overstated. In fact, trade replacement costs for Lehman counterparts turned out to be more substantial than credit losses induced by CDSs written on Lehman Brothers.⁷

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.

Present Scenario in India and RBI guidelines

In the Second Quarter Review of Monetary Policy for year 2009-10, an Internal Group was constituted by the Reserve Bank of India to finalize the operational framework for the introduction of plain vanilla OTC single-name CDS for corporate bonds in India.

Draft guidelines on CDS based on the recommendations of the Group were placed on the RBI website on February 23, 2011 and were open for comments from all concerned. Comments were received from a wide spectrum of banks, PDs and other market participants. The guidelines were suitably revised in the light of the feedback received and would become effective from October 24, 2011.

The objective of RBI for introducing Credit Default Swaps (CDS) on corporate bonds is to provide Market participants a tool to transfer and manage credit risk in an effective manner through redistribution of risk. CDS as a risk management product offers the participants the opportunity to hedge off credit risk and also to assume credit risk which otherwise may not be possible. Since CDS have benefits like enhancing investment and borrowing opportunities and reducing transaction costs while allowing risk-transfers, such products would increase investors' interest in corporate bonds and would be beneficial to the development of the corporate bond market in India.⁸

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.**⁹ 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)¹⁰
- 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)¹¹
- 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)]¹². 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)¹³.
- 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

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 Agreement¹⁴. 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 CDS¹⁵ (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).¹⁶
- 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)¹⁷
- 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 market-makers 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.¹⁸

Conclusion

The central bank in 2008 had planned to introduce the CDS for corporate bonds, but postponed the move in view of the global financial crisis, which was caused by large scale trading in such debt& derivative instruments. The experience gathered during the crisis significantly contributed to a better understanding of the market of credit default swaps. The shortcoming of US and EU regulatory framework has been carefully avoided in the RBI guidelines. Though the move of Central bank to introduce CDS in India has been much awaited and welcomed, it would be interesting to see how market participants react to specific clauses like restricting CDS contract currency to only Indian Rupee, market maker's duty to verify underlying exposure etc. There are still many areas where further clarification would be required from the RBI. Nevertheless, it is a fact that the CDS will be introduced first time in India and in the humble opinion of the authors, the robust regulatory and reporting framework should reasonably lead to the successful launch of the credit derivative market in India.

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