



International Swaps and Derivatives Association, Inc.
60 Fifth Avenue, 27th Floor
Rockefeller Center
New York, NY 10020-2302
Telephone: (212) 332-1200
Facsimile: (212) 332-1212
e-mail: isda@isda.org
website: <http://www.isda.org>

One New Change
London EC4M 9GQ
Telephone: 0171-330-3550
Facsimile: 0171-330-3555
website: <http://www.isda.org>

2nd July, 1999

Ms. Shyamala Gopinath
Chief General Manager,
Department of External Investments and Operations
Reserve Bank of India
Central Office Building, 22nd Floor
Mumbai - 400 001

Forward Rate Agreements and Interest Rate Swaps

Draft Guidelines

The International Swaps and Derivatives Association, Inc. ("ISDA"), through one of our member firms, Udawadia, Udeshi & Berjis ("UUB"), is aware of the Reserve Bank of India's ("RBI") Draft Guidelines ("Draft Guidelines") on forward rate agreements ("FRA") and interest rate swaps ("IRS"). ISDA had been forwarded an earlier version of the Draft Guidelines ("Draft Version") by UUB and subsequently downloaded the June 22, 1999 Draft Guidelines from the RBI website. ISDA greatly supports RBI's initiative to foster sound risk management procedures for these transactions. ISDA further welcomes the Draft Guidelines' endorsement of the use of the ISDA Master Agreement. The purpose of this letter is to introduce ISDA, outline ISDA's approach to a number of key issues in relation to privately negotiated derivative transactions and to suggest a possible basis for an ongoing dialogue between ISDA and the RBI.

Introduction to ISDA

Founded in 1984, ISDA is a global trade association that today represents over 430 of the world's leading participants in the privately negotiated derivatives industry, including both FRAs and IRS, as well as

currency, commodity and equity swaps, caps, floors, collars and swaptions. ISDA members consist of market-making dealers, end-users, law firms, and accounting/consulting firms. A list of current ISDA members is attached as Annex 1 to this letter.

ISDA has been in the past and continues to be instrumental in working alongside regulators and market participants worldwide to address legal uncertainties that may inhibit the efficient development of derivatives. ISDA's experience in providing assistance is founded upon:-

- **ISDA's commitment to promoting the development of sound risk management practices world-wide.** Market participants and key regulators view ISDA as a lead contributor to the debate on how best to manage the risks associated with privately negotiated derivatives transactions. ISDA's work includes on-going efforts to ensure adequate legal and regulatory treatment of privately negotiated derivatives transactions. In particular, ISDA has worked with regulators in jurisdictions around the world to promote the legal enforceability of the close-out netting mechanism in the ISDA Master Agreement, which is the leading standard form documentation for international privately negotiated derivatives transactions world-wide. ISDA's risk management initiatives include the publication in 1993 of "Derivative Practices and Principles" by the Global Derivatives Study Group of the Group of Thirty, a think tank based in Washington D.C., and the publication in August 1995 of "Principles and Practices for Wholesale Financial Market Transactions" by several trade groups representing participants in the financial markets, co-ordinated by the Federal Reserve Bank of New York and co-chaired by ISDA.
- **ISDA's extensive experience advising on derivatives-related legislation, including close-out netting legislation.** ISDA regularly advises governments and trade associations involved in drafting derivatives legislation, including close-out netting legislation. During 1998, ISDA was heavily involved in advising Italy on its recent netting legislation and continues to be involved in advising on the legal treatment of collateral arrangements involving Italian assets. In the early part of this year, ISDA advised the Czech Republic and Hungary on proposals for netting

legislation currently being considered by these countries. ISDA has also conducted discussions with central bank officials regarding netting legislation in the United Kingdom, the United States, Germany, France, Russia, the Netherlands, Japan, Hong Kong, Indonesia, Mexico, Malaysia, Singapore, the People's Republic of China, Argentina, Spain, Portugal and at the EU itself.

- **ISDA's ability to draw on the practical experience of its members to ensure that any regulations or code of conduct developed for the Indian markets will, in practice, be effective in achieving its purposes in the marketplace.** Due to its substantial and expansive membership, ISDA is in a unique position to solicit comments on any proposed regulation or guidelines to ensure that it reflects the highest standards of international market practice.
- **ISDA's ability to assemble a team of experienced market professionals and lawyers to provide technical assistance and work alongside a local development team in furthering and promoting new legislation that will facilitate advancement of the derivatives markets.** ISDA would be honoured to provide technical assistance in any areas in which RBI may feel ISDA can be helpful. By way of example, one of ISDA's recent projects has involved assembling a small development team which included representatives of key government agencies, to discuss the appropriate scope of close-out netting legislation and to draft pieces of legislation that the development team believes will be required to implement an effective solution. Moreover, if requested, ISDA's legal team would be available to offer guidance on the general policy issues faced by the officials and local development team.
- **ISDA's prominent role in the development of capital guidelines for credit and market risk by the Basle Committee on Banking Supervision.** ISDA has been a strong and early advocate of the use of internal models for determining market risk, and was a principal driver behind the Basle Committee's recognition of netting of credit risk in calculating capital requirements for financial institutions. ISDA is currently working with policymakers and supervisors to develop capital guidelines for credit derivatives and collateral arrangements.

ISDA's Comments on the Draft Guidelines

ISDA has reviewed the current Draft Guidelines, and would like to offer the following brief comments:-

First, ISDA greatly appreciates RBI's recommendation in paragraph 20 of the Draft Guidelines that participants undertaking Rupee FRAs and IRS consider using the ISDA Master Agreement. The ISDA Master Agreement has established international contractual standards governing privately negotiated derivatives that have reduced legal uncertainty, enabling users of the document to feel confident in transacting an ever-increasing number of transactions thereunder. As derivatives have continued to expand across new products and markets, ISDA has increased its activities as a trade association as well as updated the Master Agreement and produced additional supporting documents.

Second, ISDA applauds RBI's inclusion of general accounting guidelines for FRAs and IRS within the Draft Guidelines. ISDA is active in promoting sound accounting practices for derivative products. ISDA formulates position papers, responds to official and industry initiatives and works to ensure that the views of its members are adequately represented in regulatory and industry guidelines. The Association maintains a close working relationship with industry policymakers such as Financial Accounting Standards Board in the United States and the International Accounting Standards Commission.

Third, ISDA takes notice of the RBI's requirement in paragraph thirteen of the Draft Guidelines that FRA and IRS dealers exercise due diligence to ensure that their corporate customers execute the transactions only for hedging their Rupee balance sheet exposure. ISDA would note that the guidance that banks assume that measure of responsibility arguably goes beyond the scope of a number of jurisdictions that have considered this point. Further, ISDA believes that RBI would wish to ensure that its guidance is framed in a way that will not in any way call into question the enforceability of the FRA and IRS contracts themselves.

Finally, ISDA would like to comment on the Draft Guidelines' provisions for netting. Because the area of netting is of vital importance, a separate discussion is provided below.

Netting Legislation

There is a brief footnote to the Draft Version discussing netting in Annexure 1 to the Draft Version, but it appears to refer to all funded risk assets rather than to derivative transactions and implies that netting is only possible for collateralised assets. For derivative transactions, collateral and netting are two related but very distinct issues. For example, a credit decision determines whether collateral is necessary for a particular counterparty. If it has been decided that collateral is required, assessment of the underlying exposures and, in this regard, the decision of whether the counterparty's credit exposure across transactions can be netted, would presumably then influence the determination of the amount of required collateral.

Close-out netting of derivative transactions enables a party to a master agreement, upon the default of a counterparty, to terminate all existing transactions with that counterparty and to calculate a settlement amount based on the resulting net mark-to-market values. ISDA has spent more than a decade studying netting and related issues and, as part of this process has amassed a considerable library of relevant comparative law sources. As mentioned earlier, ensuring the enforceability of the netting provisions of the ISDA Master Agreement has always been and continues to be a key ISDA initiative, due to the provision's importance in reducing the credit risk arising from derivatives transactions. ISDA has obtained legal opinions from the law firms of 34 countries regarding the enforceability of the termination, bilateral close-out netting and multibranch netting provision of the ISDA Master Agreements. These opinions are updated annually to comply with requests from various central banks.

The benefits of close-out netting are *risk reduction* and *cost reduction*. The risk reduction is twofold: reduction of credit risk and reduction of systemic risk. Credit risk reduction benefits an individual party by reducing its overall exposure to its counterparty by anywhere from 40 to 60 per cent. The widespread use of master agreements providing for close-out netting also has an important beneficial effect on systemic risk. Market participants face a huge exposure to the risk of a failure of a major derivatives

participant and the subsequent risk of cascading insolvencies across counterparties. The substantial credit risk reduction achieved by close-out netting considerably lessens this consequential effect by reducing counterparty exposure at each node in the network of relationships between market participants.

Recognising the substantial credit and systemic benefits of close-out netting, many jurisdictions have thought it prudent to eliminate doubt about the enforceability of netting by introducing legislation to enable it or, more often, to strengthen it where it was already available. Examples include, in the European Union, Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, Portugal, Spain and Sweden and, elsewhere, Australia, Canada, the Cayman Islands, Japan, New Zealand, Norway, South Africa, Switzerland and the United States of America. The strongly pro-creditor position of the law in certain other jurisdictions that have been surveyed, like the United Kingdom, has obviated the need for specific netting legislation. It is important to note that even if existing law in India is thought to have a similar effect to specific netting legislation, without clear legislation, many parties will effectively be replacing credit risk with legal risk if they rely, in the absence of settled case law, on uncertain legal foundations for close-out netting. Where it is unclear whether the close-out netting provisions will be enforceable, as is the case in a number of emerging market jurisdictions, ISDA is supporting local initiatives towards netting reform. Certain of these initiatives, for example in Argentina, were commenced at the request of local regulators.

Conclusion

Naturally, there are differences among various jurisdictions in the approaches to the regulation and supervision of derivatives activity. These differences are in large part due to the nature of the regulatory authority in whose hands the regulation of derivatives falls. ISDA does not prescribe any single format for the most effective and responsible means of regulation. ISDA is pleased that the approach undertaken by RBI is consistent with ISDA's general philosophy.

ISDA greatly appreciates the opportunity to provide these initial comments on the RBI Draft Guidelines for FRAs and IRS. ISDA would be happy to provide RBI with any support or assistance as the Draft Guidelines are finalised. We would welcome any occasion to meet directly with the RBI to discuss the Draft Guidelines or to discuss ISDA's past and current efforts in derivatives risk management, regulatory, and legal issues or any other issues the RBI would like to discuss.

ISDA hopes that the RBI and ISDA can take this opportunity to build a regular dialogue. We look forward to hearing from you about how ISDA can be helpful to RBI.

Yours sincerely,

Richard E. Grove

A handwritten signature in cursive script, appearing to read "Richard E. Grove, Jr.", written in dark ink.

Executive Director and
Chief Executive Officer

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