International Swaps and Derivatives Association, Inc.
24 Raffles Place
#22-00 Clifford Centre
Singapore 048621
Telephone: 65 6538 3879
email: isdaap@isda.org
website: www.isda.org

BY COURIER AND BY E-MAIL

4 October 2010

Ms Alpana Killawala
Chief General Manager
Internal Debt Management Department
Reserve Bank of India
Central Office Building, 23rd floor
Shahid Bhagat Singh Marg
Mumbai – 400 001
INDIA
cgmidmd@rbi.org.in

Dear Madam,

DRAFT REPORT OF THE INTERNAL GROUP ON INTRODUCTION OF CREDIT DEFAULT SWAPS ("CDS") FOR CORPORATE BONDS

ISDA and its members deeply appreciate the opportunity to provide feedback and comments on the draft report issued by the Reserve Bank of India ("**RBI**"). As you know, ISDA and its members are in support of the introduction of credit derivatives in India and ISDA has made a number of written submissions[1] to RBI and has also engaged in several discussions with RBI on this topic. ISDA would like to reiterate at the outset that it stands ready to assist RBI, the Fixed Income Money Market and Derivatives Association of India ("**FIMMDA**") and market participants in the launch and development of the credit derivatives market in India.

I. CDS for Indian Markets – Product Design

Report recommendations

1. Eligible participants: The report recommends as follows:

[1] Submissions dated 4 June 2010, 17 July 2008, 7 November 2007 and 15 June 2007.

(a) An eligible participant must be an Indian resident[2].
(b) A Market-maker can be both a protection seller and a protection buyer.
(c) A User can only be a protection buyer.
(d) Only commercial banks ("**CB**"), primary dealers ("**PD**"), non-banking financial companies ("**NBFC**") offering credit facilities to borrowers, and each meeting certain specified eligibility criteria will be eligible to be Market-makers. Insurance companies and mutual funds, if so permitted by their respective regulators, may also be permitted to be Market-makers.
(e) Only CBs, PDs, NBFCs, insurance companies, mutual funds, housing finance companies, provident funds, listed corporates and such other institutions as may be permitted by RBI will be eligible to be Users.
(f) All transactions must have an RBI-regulated entity on at least one side of the trade.[3]
(g) Market-makers and Users cannot enter into transactions with their related parties[4] as counterparty or as the Reference Entity.

2. Users must have underlying exposure: The report requires Users to have an underlying exposure to hedge:

(a) The underlying exposure must be an Indian Rupee ("**INR**") bond that is a direct obligation of an Indian resident[5] entity that is rated[6] and where the bondholders are Indian residents[7]. The rating must be current and must be published in the rating agency's monthly bulletin. In addition, the bond must have an original maturity of more than one year and be in dematerialized form. Asset-backed securities, mortgage-backed securities and convertible bonds are not allowed.
(b) The amount of protection that is bought cannot exceed the face value of the bond held by the protection buyer.
(c) The tenor of protection that is bought cannot exceed the remaining tenor of the bond held by the protection buyer.
(d) If the User ceases to hold the bond (or part thereof), the protection buyer must terminate the CDS (or the corresponding portion thereof) with the original protection seller – it cannot unwind the CDS position by entering into an offsetting contract.

3. Protection that can be sold by Market-makers: The report provides that Market-makers "should ensure not to sell protection on reference entities/obligations on which there are regulatory restrictions on assuming exposures (in the cash market)"[8] and that "the protection

---

[2] As defined in Section 2(v) of the Foreign Exchange Management Act ("**FEMA**").
[3] Due to the provisions of Section 45V of the Reserve Bank of India Act.
[4] As defined in Indian Accounting Standard 18 – Related Party Disclosures, which in the case of foreign banks operating in India, includes entities that are related parties to the foreign bank, its parent or group entity.
[5] As defined in Section 2(v) of FEMA.
[6] There is one exception – where the bond issuer is a special purpose vehicle ("**SPV**") sponsored by an infrastructure company that is rated, the SPV need not be rated.
[7] As defined in Section 2(v) of FEMA.
[8] Section 2.6 of the report.

seller shall not transact in CDS with reference assets/obligations or deliverable assets/obligations which they are not permitted to undertake, as per extant RBI instructions"[9].

4. Market-makers' duty to verify underlying exposure: The report requires that "[p]roper caveat may be included in the agreement that the protection seller, while entering into the CDS contract/unwinding, needs to ensure that the protection buyer has exposure in the underlying. This may also be subject to rigorous audit discipline"[10] and that the "[s]eller may ensure that the user is having exposure in the underlying bond while buying/unwinding the CDS and that the bond is in demat form"[11].

5. CDS terms: The report makes the following recommendations:

(a) "Therefore, it is proposed to introduce CDS only on corporate bonds as reference obligations in India."[12]
(b) "CDS shall not be written on entities which have not issued any bonds and have only loan obligations."[13]
(c) "[T]he reference asset/obligation and the deliverable asset/obligation shall be to a resident and denominated in Indian Rupees".[14]
(d) "For the purpose of transparency and wider dissemination of information, the eligible underlying of a specific obligor covered by the CDS contract should be specified *a priori* and reviewed periodically.[15]
(e) Restructuring not be allowed as a Credit Event in the initial stages, given that "[i]n the Indian context, the prevalence of frequent restructuring of obligations by banks may trigger CDS payments if restructuring is classified as a credit event. India-specific aspects like restructuring of loan and their impact on CDS should be assessed before its inclusion in list of credit events."[16]

6. Standardization: The report recommends the standardization of CDS contracts in terms of coupon, coupon payment dates, etc. and that market participants and market bodies like FIMMDA should decide the standard terms, keeping in view the international practices and the objective of ultimately moving to a central clearing platform.

7. Determinations Committee: The report recommends that a Determinations Committee ("**DC**") based in India and comprising Indian participants be formed (with at least 25% of the members being drawn from the Users or buy-side) on the lines of such committees established in other markets. The report requests FIMMDA to take an active role in co-coordinating market initiatives to establish the Indian DC.

[9] Section 2.9(xvii) of the report.
[10] Section 2.7.6(iii) of the report.
[11] Section 2.9(xviii) of the report.
[12] Section 2.6 of the report.
[13] Section 2.9(vii) of the report.
[14] Section 2.9(iv) of the report.
[15] Section 2.6 of the report.
[16] Section 2.11.3 of the report.

8. Documentation: The report requests market organizations like FIMMDA, in association with ISDA, to devise a master agreement for Indian CDS and given that there will be two sets of transactions, that is, transactions between a User and a Market-maker, and transactions between two Market-makers, that it may be appropriate to have two sets of documents. The report suggests that some modification of the ISDA definitions of Credit Events may be required to be in consonance with Indian laws.

9. Accounting: The report requires market participants to adopt appropriate norms for accounting of CDS that are in compliance with Indian accounting standards from time to time, with the approval of their respective boards of directors. The report, however, also requires accounting norms to be on the lines indicated in Indian Accounting Standard ("**AS**") 30 – Financial Instruments: Recognition and Measurement, and also highlights AS 31 – Financial Instruments: Presentation and AS 32 – Disclosures as being relevant.

10. Pricing/Valuation: The report requires market participants to put in place appropriate and robust methodologies for marking-to-market the CDS contracts on a daily basis and also, to assess hedge effectiveness, wherever applicable. Further, the report requires such internal methodologies to be externally validated. For this purpose, the report requests FIMMDA to co-ordinate with service providers/ISDA to come out with a daily CDS curve.

ISDA's comments

11. Purpose behind introduction of credit derivatives in India: As mentioned in the report[17], there is a two-fold objective in introducing credit derivatives in India, namely:

(a) provide a credit risk transfer tool to Indian market participants, enabling them to manage credit risk in an effective manner through redistribution of credit risk; and
(b) encourage the growth and development of the corporate bond market.

12. Report recommendations may not achieve these objectives: We believe that neither of these objectives may be achieved if credit derivatives are permitted in India upon the terms outlined in paragraphs 1 to 5 above. We believe that the above objectives can best be achieved only if RBI's initiative leads to the establishment of a liquid, efficient and complete CDS market.

13. Liquid, efficient and complete markets: To quote from ISDA's Research Note, Issue Number 2, 2010 entitled *The Economic Role of Speculation*[18] ("**ISDA RN2/2010**"), a *liquid* market is one in which it is possible to transact immediately with minimum effect on price and minimum loss of value. Even when prices do change as the result of trading, in liquid markets, they return quickly to their former levels. There are four dimensions of liquidity, that is, immediacy, cost, depth, and resiliency. *Immediacy* refers to how long it takes to transact at a given cost in a given size. *Cost* takes the form of the bid-offer spread. *Depth* refers to the ability to transact in large size at a given price. *Resiliency* refers to the speed with which prices revert to their former levels in those instances where trading causes prices to move. Market *efficiency* refers to the degree to which market prices are informative, that is, reflect fundamental values.

[17] Section 1.4.4 of the report.
[18] http://www.isda.org/researchnotes/pdf/SpeculationRN.pdf.

Market *completeness* means that those wishing to hedge a risk can find an interested party to take the other side. Market completeness applies over time as well as across locations and products.

14. Need for informed traders: In Section 2.7.5, RBI has summarized very well the arguments for and against allowing naked CDS. We only wish to emphasize that there is a need for informed traders for a liquid, efficient and complete marketplace, that is, participants who take on appropriate risk in order to profit from their ability to form a view as to what will happen to prices in the future based on their considered analysis and interpretation of publicly available market information. We do not think that Market-makers, in general, will be equipped to play the role of informed traders. As pointed out in the ISDA RN 2/2010, dealers or market-makers facilitate trading by others by holding themselves out as financial intermediaries willing to buy or sell at bid or offer prices. Although market-making might yield some information that leads to profitable opportunities, dealers do not trade primarily on the basis of informational advantages.

15. Empty creditor hypothesis: In relation to Section 2.7.4, we would like to refer you to ISDA's Research Note, Issue Number 3, 2009 entitled *The Empty Creditor Hypothesis*[19] ("**ISDA RN 3/2009**") which concludes that based on the available evidence, in the form of restructuring choices by distressed firms as well as market practices surrounding credit derivatives, the plausibility of the empty creditor hypothesis is questionable.

16. Report recommendations may result in a skewed market and risk accumulation in the banking system: The market permitted by the report may result in a skewed market. Bondholders of the qualifying bonds who meet the eligibility criteria for a User will be allowed to buy protection. Given their homogeneous nature, it is likely that they will share a broadly similar credit outlook and will want to buy protection largely at the same time. The only sellers of protection will be those institutions that are eligible to be Market-makers. Further, though the report envisages the possibility of insurance companies and mutual funds being permitted to be Market-makers, we expect that this will not, in any event, happen at the outset. Thus, the Market-makers will likely be limited to CBs, PDs and NBFCs offering credit facilities and who meet the eligibility criteria. Again, given their homogeneous nature, it is likely that they will share a broadly similar credit outlook and will want to sell or not sell protection largely at the same time. Apart from perhaps a handful of institutions, it is equally unlikely that any of them will possess any special informational advantages[20] to have a divergent view-point and thus, play the role of an informed trader. Another outcome will be the accumulation of risk in the banking system as RBI-regulated entities will be the only protection sellers. The imposition of the risk management limits and other measures recommended by the report may prove to be an inadequate mitigant to the accumulation of risk within the banking system.

17. Open market is the best: In the circumstances, we reiterate our request that there should ideally be no restrictions on who can participate in the market as protection sellers and protection buyers and that naked CDS should be allowed.

---

[19] http://www.isda.org/researchnotes/pdf/ISDA-Research-Notes3.pdf.

[20] Please note that this refers to publicly available market information. The applicability of insider trading laws to credit derivatives is an evolving area. Best market practice, however, requires banks to implement firewalls or Chinese walls between their lending and trading desks so that traders cannot profit from the use of information that the bank's lending side may have privately gleaned from borrowers in the course of assessing their creditworthiness.

18. <u>At a minimum, pool of protection sellers must be enlarged</u>: However, recognizing that RBI may not accept (at least upon the initial launch of the CDS market) that an open market is feasible, we submit that, at a minimum, the pool of protection sellers needs to be enlarged. We submit that all deposit-taking NBFCs and non-deposit taking NBFCs that are deemed to be systemically important ("**NBFCs-ND-SI**") by RBI should be allowed to be Market-makers. Thus, the qualifying criteria set out in Section 2.3.2(a) should be replaced with asset size of INR 100 crores.[21] To be consistent, this criterion should similarly be amended in Section 2.3.3(a) for PDs. Further, we submit that, in the interest of a level playing field, the same minimum Capital to Risk-Weighted Assets Ratio should be applied to CBs, NBFCs and PDs (whether this is the 10% applicable to NBFCs-ND-SI, or 12% or 15%). Apart from leverage, selling protection is no different from buying the bond. Thus, we submit that any institutional investor that is able to buy the bond, can demonstrate that it has a risk management policy and can provide collateral should be allowed to sell protection on the bond.

19. <u>Foreign participation</u>: Another measure to enlarge the pool of protection sellers is to allow non-Indian residents to participate in this market. Foreign Institutional Investors that are permitted to buy INR bonds could be permitted to sell protection. Market-makers could also be allowed to lay off their credit risk by buying non-INR CDS[22] from non-Indian resident sellers. In this regard, we request RBI to reconsider the prohibition against dealing with their related parties as counterparty. We note that this prohibition[23] arises out of RBI's concerns about the difficulty of determining whether an arms' length relationship exists given the lack of an objective and transparent price discovery mechanism. We believe that this concern should be weighed against the greater good that could be achieved by allowing the Indian branch or subsidiary of a foreign bank to lay off its risk to its offshore related parties who would be better positioned to manage such risk.

20. <u>Publication and maintenance of list of Market-makers</u>: We request that RBI publish and maintain on its website an up-to-date list of eligible participants, that is, CBs, NBFCs and PDs. A similar request is made in respect of insurance companies and mutual funds when their eligibility criteria are prescribed by their respective regulators.

21. <u>Corporate bond market</u>: An illiquid, inefficient or incomplete CDS market will also not encourage the growth and development of the corporate bond market. For example, a wide bid-offer CDS spread may have an adverse impact on the corporate bond market as bond investors would have to demand higher bond yields in order to pay for the cost of buying protection.

22. <u>Corporates as Users</u>: We submit that listing not be considered as a pre-condition as there are several non-listed corporates that would have the requisite and appropriate sophistication, risk management ability and accounting standards. There are over 6,000 companies listed on the Bombay Stock Exchange and the National Stock Exchange and there will clearly be a significant

---

[21] *RBI's Circular on Financial Regulation of Systemically Important NBFCs and Banks' Relationship with them*, RBI/2006-07/204DNBS.PD/ CC.No. 86/ 03.02.089 /2006-07 dated 12 December 2006 - http://www.rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=3207.

[22] The Market-maker will have to manage the foreign exchange risk but this is very much par for the course for them.

[23] Section 2.8 of the report.

variance in standards between them. We submit that eligible corporate Users should be aligned with the criteria that RBI will adopt in regard to corporates that will be allowed to engage in cost reduction structures under RBI's revised Guidelines on Over-the-Counter Foreign Exchange Derivatives and Overseas Hedging of Commodity Price Risk and Freight Risk ("**OTC FX Guidelines**")[24], that is, listed corporates and unlisted corporates of a certain size[25] that can demonstrate that they have a risk management policy in place. In addition, unlisted subsidiaries and affiliates of listed corporates should also be allowed to be a User.

23. Unwinding of CDS position by Users: The report requires a User who ceases to hold the underlying bond (or part thereof) to terminate the CDS (or the corresponding portion thereof) with the original protection seller. As the User has no choice but to take whatever price is offered, there is no incentive for the original protection seller to provide the best unwind price to the User. To provide more options to Users, we suggest that, subject to a User obtaining the consent of the original protection seller to a novation or transfer of the CDS (or the relevant portion thereof), such User should be allowed to sell the CDS (or the relevant portion thereof) to the party to whom the User has sold the underlying bond (or part thereof) and/or to other Market-makers.

24. Protection that can be sold by Market-makers: The report requires Market-makers to ensure that they do not sell protection where there are regulatory restrictions on assuming exposures (in the cash market) and that they do not transact in CDS with reference assets/obligations or deliverable assets/obligations which they are not permitted to undertake, as per extant RBI instructions. Our members presume that RBI has in mind restrictions such as the restriction against banks holding unrated bonds[26], and single/group exposure limits[27]. We would appreciate RBI clarifying if there are any other specific restrictions or instructions that it has in mind. Further, to avoid any ambiguity arising from differing interpretations as to how regulatory requirements that are designed for the cash market or physical holdings will apply in the derivatives space, we submit that specific cross-references, if not guidelines (such as has been enunciated in the report in regard to single/group exposure limits) should be issued in place of the broad generic language used in the report. There should also be an explicit statement whereby RBI clarifies (for the avoidance of doubt) that any breach of such guidelines would not invalidate the CDS contract or render the CDS contract unenforceable.

25. Market-makers' duty to verify underlying exposure: The most that a Market-maker can do to verify that a User has the requisite underlying exposure when entering into or unwinding a CDS is to obtain a written representation, warranty and undertaking to this effect from the User, and to refuse to transact if the User does not do so. The Market-maker would not be able to obtain information on the User's bondholding from the relevant custodian of the dematerialized bonds (that is, the National Securities Depository Limited or the Central Depository Services (India) Limited) and perforce has to rely on the User. Further, to the extent that RBI's guidelines would impose any such duty to verify underlying exposure on the Market-makers, we submit that the guidelines should state explicitly (for the avoidance of doubt) that any breach of such

[24] http://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=22872.
[25] We support FIMMDA's submission on the OTC FX Guidelines that this should be INR 100 crores.
[26] Please also refer to our comments in paragraph 28 below.
[27] We note that the report (Section 3.7.3.3) requires protection sold on a Reference Entity to be included in the single/group exposure limits of the Reference Entity/group.

duty would not invalidate the CDS contract or render the CDS contract unenforceable. In order to deter Users from giving false undertakings, we request RBI to provide deterrence on the lines set out in the OTC FX Guidelines. ISDA had, in paragraph 2 of its submission of 15 December 2009[28] on the OTC FX Guidelines, made certain submissions and we request that the same be applied in the CDS guidelines as well.

26. 2003 ISDA Credit Derivatives Definitions: Under the 2003 ISDA Credit Derivatives Definitions (as amended) (the "**Definitions**"), a protection buyer buys credit protection in respect of a **Reference Entity** against specified **Obligations** of the Reference Entity, and these Obligations can either be direct Obligations of the Reference Entity or Obligations of another party[29] that are guaranteed by the Reference Entity. The credit protection is only against specified **Credit Events** occurring with respect to the specified Obligations[30]. If a specified Credit Event does occur with respect to any of the specified Obligations[31], upon satisfaction of the **Conditions to Settlement** by the protection buyer, the CDS will be settled pursuant to the **Settlement Method** chosen by the parties. There are three Settlement Methods available: (i) **Auction Settlement**, (ii) **Cash Settlement**, and (iii) **Physical Settlement**. Where Cash Settlement applies, it is necessary to specify the **Reference Obligation** as the Cash Settlement Amount will be fixed based on the price of the Reference Obligation. Where Physical Settlement applies, it is necessary to specify the **Deliverable Obligations** which again, can either be direct Obligations of the Reference Entity or Obligations of another party that are guaranteed by the Reference Entity. In the case of Auction Settlement, a **Fallback Settlement Method** (either Cash Settlement or Physical Settlement) needs to be specified[32]. We set out in the attached table further details on this, together with the market standard terms for a CDS on an Asian corporate (which includes an Indian corporate) traded in the offshore market.

27. Direct Obligations and Deliverable Obligations: With regard to the Reference Entity, the report does not elaborate on the reason for limiting the Obligations to direct obligations of the Reference Entity. We submit that obligations guaranteed by the Reference Entity should also be permitted as Obligations and Deliverable Obligations.

28. Rating requirement: The report explains that the imposition of a rating requirement is driven by the restriction against banks holding unrated bonds[33], to enable better price discovery and more transparency and to ensure that all the deliverable obligations for a specific obligor are pari passu in terms of their seniority[34]. While, on the day on which the CDS is entered into, the Reference Entity may have a current rating that is being published in the rating agency's monthly bulletin, it is conceivable that the Reference Entity may cease to be rated during the tenor of the CDS. The report is silent on what is to happen in such a case. We are of the view that it would not be appropriate to make it mandatory to terminate the CDS in such an event. If the cessation

[28] Copy of submission attached.
[29] This other party could either be anyone (including unrelated third parties) or only Downstream Affiliates (essentially subsidiaries) of the Reference Entity.
[30] Except, of course, that no Obligations are required where the Credit Event is Bankruptcy.
[31] Except, of course, that no Obligations are required where the Credit Event is Bankruptcy.
[32] However, if the parties do not make an express specification, the Definitions provide that Physical Settlement will be the Fallback Settlement Method.
[33] Section 2.5.2 of the report.
[34] Section 2.5.3 of the report.

of the rating is driven by credit impairment, the protection buyer will lose his protection when he most needs it. There may also be other causes behind the cessation of the rating and there may be a possibility of another agency commencing rating of the Reference Entity. Thus, we submit that the only practicable condition is to require that the Reference Entity have a current rating that is being published in the rating agency's monthly bulletin as of the trade date of the CDS. This would also be comparable to the position where a bank can only verify at the point of purchase of the bond that the bond is rated – once it has bought the bond, the bank cannot sell back the bond even if the bond subsequently loses its rating. The fact that a bond is rated does not necessarily enable better price discovery and more transparency. A rated bond that hardly trades will not lead to better price discovery. Unless the traded prices are reported and published, there will be no transparency. Under the Definitions, ratings are irrelevant to the seniority of ranking of the Deliverable Obligations. By specifying **Not Subordinated** as a **Deliverable Obligation Characteristic**, only obligations that are not subordinated to any unsubordinated **Borrowed Money** obligations of the Reference Entity can be delivered (or if Reference Obligations have been identified in the CDS contract, not subordinated to the most senior Reference Obligation in priority of payment).

29. CDS terms: The report suggests that in a transaction between a Market-maker and a User, Physical Settlement must be the Settlement Method, and the Deliverable Obligation should only be the underlying bond. Apart from this, we submit that parties should be left to decide what will constitute the Obligations, the Reference Obligation (in the case of Cash Settlement) and/or the Deliverable Obligations (in the case of Physical Settlement between two Market-makers). The requirement in Section 2.9(vii) that CDS cannot be written on entities which have not issued any bonds may not be necessary. In our view, the requirement for periodic review of the eligible underlying of a specific obligor covered by the CDS contract needs clarification – once the CDS has been entered into, it is a binding contract and there is no unilateral right to change the terms of the contract. We would also appreciate confirmation that the requirements set out in Section 2.9(x) to (xiii) are intended to reflect the Basel II requirements.

30. Restructuring: Under the Definitions, a **Restructuring** Credit Event occurs only if any one or more of the following occurs with respect to one or more Obligations in an aggregate amount of not less than the **Default Requirement**[35]:

(a) A reduction in the rate or amount of interest payable.
(b) A reduction in the amount of principal.
(c) A postponement of payment of interest or principal.
(d) A subordination in the priority of payment.
(e) A change in the currency or composition of any payment of interest or principal to a non-Permitted Currency.

However, under the Definitions, none of the above events will constitute a Restructuring if such event does not directly or indirectly result from a deterioration in the creditworthiness or financial condition of the Reference Entity. As Restructuring is constituted only if the relevant event stems from credit impairment, we see no logical basis for disallowing the inclusion of

[35] If the parties have not expressly specified the amount of the Default Requirement, the Definitions provide that it is USD10,000,000 (or its equivalent in the currency(ies) in which the relevant Obligations are denominated).

Restructuring as a Credit Event. Indeed, disallowing Restructuring may incentivize lenders or bondholders who have bought credit protection to vote against the restructuring proposal so that the company will default in payment (thus triggering a Failure to Pay Credit Event) or to push the company into insolvency proceedings (thus triggering a Bankruptcy Credit Event).[36] In addition, given that the offshore market for Indian corporates trades with Restructuring included as a Credit Event, disallowing it in the onshore market could lead to basis risk and potential arbitrage opportunities.

31. Proposed CDS terms: In the circumstances, we submit that the following should be allowed:

	Market-maker/User Transactions	**Inter-Market-maker Transactions**
Obligations		
Obligation Categories	Bond or Loan	Bond or Loan
Obligation Characteristics	Up to parties to agree	Up to parties to agree
Credit Events	Up to parties to agree	Up to parties to agree
Conditions to Settlement	Up to parties to agree	Up to parties to agree
Settlement Method	Physical Settlement	Up to parties to agree
	Deliverable Obligations – underlying bond only	

32. Standardization: Standardization in the User/Market-maker segment will not be possible so long as it is a requirement that the CDS bought by the User must hedge an underlying exposure. In the inter-Market-maker segment, standardization would be premature at this stage. For CDS contracts to be standardized, the items that would need to be determined are the following:

(a) Number of coupons.
(b) Coupon rates.
(c) Recovery rate assumptions for senior and subordinated debt.
(d) Whether to apply a flat CDS curve assumption.
(e) Whether to align coupon payment dates with the IMM roll dates of March 20, June 20, September 20 and December 20.
(f) Whether to align Scheduled Termination Dates with the IMM roll dates.
(g) Whether a full coupon should be paid for the initial coupon period.
(h) When upfront payment settlement should be made (T+3 or other).

[36] ISDA RN 3/2009 concludes that at most, it is possible that a debt holder, under current credit default swap terms (that is, which does not include restructuring) might oppose an out-of-court restructuring in favor of bankruptcy for the simple reason that a restructuring could lead to an economic loss while bankruptcy would trigger a credit event and lead to full compensation.

Depending on the market concerned, there are differences in the above terms. For example, while North America and Asia trades with two coupons (1% and 5%), Japan trades with three (0.25%, 1% and 5%) and Europe trades with four coupons (0.25%, 1%, 5% and 10%). Again, while North America, Europe and Asia applies a recovery rate assumption of 40%/20% for senior/subordinated debt, Japan applies a recovery rate assumption of 35%/15%. While one approach could be to apply the Asian standardization terms (which includes non-INR debt obligations of Indian corporates) to the Indian CDS, we would recommend that this be re-visited after there has been at least some trading volume in the Indian CDS market so that a realistic assessment can be made as to what the standard terms should be.

33. Determinations Committee: The role of the DCs is to make legally binding determinations on issues that impact the credit derivatives markets as a whole (such as whether a Credit Event has occurred, or whether an auction should be held and the terms for such an auction), thereby reducing counterparties' basis risk, and increasing transparency and predictability in the credit derivatives markets. Establishing the DC infrastructure and maintaining the DCs on an on-going basis is a huge undertaking in and of itself - this needs to be a very robust and transparent process to give the requisite assurance to market participants who are legally bound by the determinations of the DCs. Given the size of the global credit derivatives markets, the effort and expense of establishing and maintaining the DCs is clearly justified. Given that the Indian CDS market will likely be limited, at least in the near term, we believe that it would be premature at this stage to establish an Indian-based DC. Whether a Credit Event has occurred should be determined in the traditional manner, that is, bilaterally between the parties. Auctions will not feature in the User/Market-maker segment given RBI's requirement that these trades be physically settled. In the inter-Market-maker segment, as the Market-makers are likely to be only RBI-regulated entities, the concern as to basis risk would largely be addressed by the issuance of a market practice statement by FIMMDA as to the Final Price. In any event, we request RBI to consider the possibility of using ISDA's existing DC infrastructure and welcome the opportunity to discuss further how this might be implemented in future. The added advantage of leveraging off ISDA's existing DC infrastructure is that it would reduce the basis risk and potential arbitrage opportunities that may arise from different determinations being made by the Indian-based DC for onshore trades and ISDA's Asia Ex Japan DC for offshore trades.

34. Documentation: ISDA and FIMMDA have already held discussions on working together to develop ISDA-based documentation to cater for transactions between a User and Market-maker, and transactions between two Market-makers. As part of this exercise, we will consider, together with FIMMDA and our respective memberships, whether any amendments may be required to the standard ISDA definitions of Credit Events. Our discussions have also identified the following Indian-specific legal concerns that would need to be addressed:

(a) Banks and other eligible participants buying and selling non-performing assets: In *Kotak Mahindra Bank v. Official Liquidator, APS Star Industries Ltd* (O.J.Appeal No. 156 *of* 2007), the Gujarat High Court held that the buying and selling of non-performing assets ("**NPAs**") is not part of "banking activity" as contemplated under the Banking Regulation Act, 1949 ("**BR Act**") and is therefore illegal. We understand that the Supreme Court of India ("**SC**") has, on 30 September 2010, set aside the High Court judgment. Notwithstanding the SC

judgment, since the ability of the banks to deal in NPAs is critical to the functioning of the credit derivatives market, it would be ideal if the Central Government could publish, pursuant to Section 6(1)(o) of the BR Act, a notification in the Official Gazette specifying that the buying and selling of NPAs is a form of business in which banks can engage. In addition, as it is important that other eligible participants such as NBFCs, insurance companies and mutual funds are able to deal in NPAs, their position should also be carefully considered and appropriate measures taken.

(b) RBI's Guidelines on NPAs: We understand that certain aspects of the *RBI Guidelines on Purchase/ Sale of Non Performing Assets*, DBOD.NO.BP. BC. 16 / 21.04.048/ 2005-06 dated 13 July 2005[37] will need to be amended in order to facilitate the trading of NPAs in a manner that will meet the needs of the credit derivatives market. Our members will follow up with more specific details of the amendments required.

(c) Insurance carve-out: Given the requirement that Users can only buy protection to hedge an underlying exposure, we are concerned that this raises the risk of a CDS sold to a User being deemed to be an insurance contract[38], which would then require Market-makers to be licensed and regulated under the Insurance Act. Our members that are RBI-regulated entities are anxious for this to be explicitly clarified as the need to be licensed and regulated as an insurance company in order to be a Market-maker is a huge deterrent.

35. Accounting: We request clarification of the accounting treatment required of corporates who currently do not adopt AS 30 to 32. We understand that only 39 of the top 200 companies in India currently adopt these accounting standards. It is not practicable to insist on partial adoption as these standards have far larger implications for a corporate's balance sheet than just derivatives accounting. Thus, it is not clear what is expected by the report's recommendation that accounting norms be applied that are "on the lines indicated" in such accounting standards.

36. Pricing/Valuation: We support the recommendations made in the report and will do what we can to facilitate the creation and publication of a daily CDS curve. From preliminary discussions, it seems possible to create a daily CDS curve based on end-of-day CDS bid and offer quotes from Market-makers. However, even though it may be possible to create such a curve, we would caution that, until there is a truly functioning trading market, the curve would not necessarily be a good indicator of mark-to-market value (notwithstanding any "cleaning-up" process that may be applied to the quotes submitted).

II. Regulation and Risk Management in CDS

Report recommendations

[37] http://rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=2372.

[38] An insurance contract, at common law, is a contract the object of which is to protect against the risk of loss. We attach a copy of the opinion of Robin Potts, QC dated 19 May 1997. We understand that the position under Indian law would be similar.

1. Position limits and risk indicators: The report makes various recommendations, including defining market risk limits, stress testing and chalking of credit exposure limits.

2. Margining: The report requires all participants to put in place a margin policy and requires net CDS exposures to be margined on a daily basis, using cash or government securities.

3. Risk governance: The report requires all participants to establish sound risk management policy and procedures and integrate the same into their overall risk management. The risk management policy should cover at a minimum:

   (a) Strategy, that is, whether for hedging or for trading, risk appetite and limits.
   (b) Authorization levels and identification of those responsible for managing the business.
   (c) Procedures for measuring, monitoring, reviewing, reporting and managing associated risks like credit risk, market risk, liquidity risk and other specific risks.
   (d) Appropriate accounting and valuation principles for CDS.
   (e) Determination of contractual characteristics of the products.
   (f) Use of best market practices.

4. Prevention of mis-selling and market abuse: The report recommends that Market-makers must obtain from the counterparty a copy of the Board of Directors' resolution authorizing the entry into the CDS transaction. It also recommends that the product terms are transparent and clearly explained to counterparties along with the risks involved.

ISDA's comments

5. Position limits and risk indicators: We support these recommendations and our members will provide further feedback when the detailed implementation measures are announced.

6. Margining: Where there is a broader trading relationship between the parties, it should be the net exposure across all the transactions and not just the CDS transactions that should be margined. While we fully support daily margining, we understand that there are Indian-specific regulatory requirements that prevent daily margining in certain circumstances[39]. Similarly, while we support the use of government securities as collateral, we understand that there are practical problems that impede the use of government securities as collateral[40].[41]

[39] We understand that RBI expects Indian banks to comply with the requirements applicable to term deposits when banks receive INR cash as collateral, including under the ISDA English law Credit Support Annex. Thus, where the transferor is not another Indian bank, in practice, the transferee can only pay interest on the cash received if it is held for at least 7 days. This has meant that, for non-interbank transactions, margining cycles have to be not less than 7 days.

[40] We understand that it is not possible to report transfers of Indian government securities for zero cost on RBI's Negotiated Dealing System.

[41] We attach a copy of the collateral opinion issued by JurisCorp on 14 July 2010 for your reference.

7. Risk governance; Prevention of mis-selling and market abuse: While we support these recommendations, we request that RBI's Comprehensive Guidelines on Derivatives, DBOD.No.BP.BC. 86/21.04.157/2006-07 dated 20 April 2007[42] is extended to apply to CDS or that effort be made to avoid duplication and inconsistencies. Given that only plain vanilla single name CDS will be allowed, we believe that the risk of mis-selling is low. We submit that any duty of care or disclosure should only be applicable where a Market-maker is dealing with a User, and not when it is dealing with another Market-maker.

III Trade Reporting and Information Dissemination

Report recommendations

1. Transparency: The report highlights the concerns that had arisen during the financial crisis in 2008 from the fact that regulators and market participants simply did not know the extent of credit risk that had been assumed or transferred through CDS and could not identify the firms with significant CDS exposures. The report emphasizes the importance of data collection both for regulatory surveillance and market dissemination, and makes the following recommendations:

(a) Centralized trade information repository: A centralized trade information repository be set up, leveraging off the proposed comprehensive reporting platform for all OTC derivatives.

(b) Reporting requirements: It is made mandatory for Market-makers to report a CDS trade within 30 minutes from its deal time. RBI-regulated entities will also be required to submit a fortnightly report to RBI as per the proforma set out in Annex IV to the report.

(c) Data publication: Data be made available to regulators for surveillance and regulatory purposes and that the repository publish, for market information, relevant price and volume data on CDS activities such as notional and gross market values for Reference Entities broken down by maturity, ratings, etc., gross and net market values of CDS contracts and concentration level for major counterparties.

(d) Lifecycle event processing: The repository provide lifecycle event processing services to manage all phases of the CDS post-trade process, such as calculation of payments, bilateral netting, and automation of processing of events such as successor events.

ISDA's comments

2. Transparency: Since transparency can mean different things to different people, we believe it necessary to first arrive at a common understanding of what is meant by transparency. In this regard, we refer to ISDA's Research Note, Issue Number 1, 2009 entitled *Transparency*

---

[42] http://www.rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=3432.

and over-the-counter derivatives: The role of transaction transparency[43] ("**ISDA RN1/2009**"). Transparency can mean risk transparency, that is, the transparency of risks undertaken by market participants. Transparency can also mean transaction transparency, that is, information regarding prices and volumes of financial transactions. Transaction transparency, in turn takes two forms. One is *pre-trade transparency*, which refers to the reporting of information on prospective trading interest or limit order books. The other is *post-trade transparency*, which refers to the reporting of prices and volumes of completed transactions.

3. ISDA's position on transparency: ISDA fully agrees that risk transparency to the relevant regulators is a fundamental requirement. We submit, however, that there is no one answer to the question of the extent to which transaction transparency to the relevant regulators should be mandated, particularly on a regular reporting basis as compared to on an ad hoc basis (for example, we submit that pre-trade transparency is generally not required on a regular on-going basis – it is only in situations where market rigging or insider trading is suspected that such information needs to be provided to the concerned regulators). As regards transparency to the public, we submit that this should not be an end in itself, but rather, a means to an end. Regulators should push for public transparency only in those cases where it can demonstrably make markets more liquid, efficient and complete. Public policy toward public transparency should thus recognize that there rightly should be a transparency continuum that allows for the evolution of markets as they adapt to new conditions. As ISDA RN1/2009 points out, mandating a high level of public transparency in thinly-traded markets can reduce the return to operating there and lead to the exit of participants from such markets, thereby exacerbating the inherent illiquidity of such markets. In summary, we believe that India needs to carefully calibrate its regulatory reporting requirements and the extent of mandatory public transparency bearing in mind (i) the purposes that it hopes to achieve by requiring such transparency, (ii) the stage of development of the market, that is, the fact that the CDS market will likely be a thinly-traded market to start with, and (iii) the operational cost and expense to participants.

4. Centralized trade data repository: Once the repository is in place, parallel reporting to the regulators should be eliminated as much as possible, that is, participants should only have to provide data to the repository that will, in turn, provide such data to the regulators. We submit that the factors enunciated in the Consultative Report entitled *Considerations for trade repositories in OTC derivatives markets* published in May 2010 by the Committee on Payment and Settlement Systems of the Bank for International Settlements ("**BIS-CPPS**") and the Technical Committee of the International Organization of Securities Commissions ("**IOSCO-TC**")[44] should be taken into account in establishing a domestic repository.

5. Trade repositories and trade warehouses: The distinction between trade repositories and trade warehouses tends not to be clearly understood. A trade repository collects key transactional information, collates such information and provides such information in a format that is usable ("data" as compared to the raw "information") with the objective of promoting transparency. A trade warehouse, in addition to performing the role of a trade repository, provides additional services, that is, lifecycle event processing. Lifecycle event processing

---

[43] http://www.isda.org/researchnotes/pdf/ISDA-Research-Notes1.pdf.
[44] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD321.pdf.

services reduces operational risk and increases efficiency but is not essential to the objective of promoting transparency. Thus, while it is a laudable goal for the trade repository to evolve into a trade warehouse, we submit this should be a market-driven imperative (if trade volumes remain low, there will be no commercial imperative for a trade warehouse). Accordingly we request re-consideration of any regulatory directions in this regard.

IV Centralized Clearing and Settlement of CDS

Report recommendations

1. Central Counterparty: The report recommends that India takes a gradual approach to developing a suitable framework for a central counterparty ("**CCP**") based on international experience, but allowing for the specific features of the Indian markets after examining the development of the domestic CDS market. It suggests that to start with, non-guaranteed settlement of CDS could be offered, covering collection of trade data from the trade repository, and providing mark-to-market and collateral management services to participants.

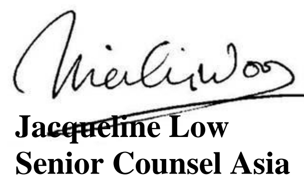
ISDA's comments

2. CCP: We agree that a gradual approach needs to be taken to the implementation of a CCP and like the evolution of a trade warehouse, we believe that market forces are a key driver of whether a CCP is required. If trade volumes remain low, or if trades do not become standardized, central clearing will neither be needed nor possible. We believe that India should also consider the possibility of using an offshore CCP instead of developing its own domestic CCP. In any event, the recommendations made in the Consultative Report entitled *Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC derivatives CCPS* published in May 2010 by the BIS-CPPS and the IOSCO-TC[45] should be taken into account in establishing a domestic CCP. Care will be needed to avoid duplication and overlap of non-guaranteed settlement services and lifecycle event processing services (especially if these are mandated rather than left to market forces).

We look forward to continuing to work with RBI, FIMMDA and market participants in launching and developing the credit derivatives market in India. Please do not hesitate to contact Mr Keith Noyes (knoyes@isda.org) at +852 2200 5909 or Ms Jacqueline Low (jlow@isda.org) at +65 6538 3879.

Yours faithfully,

For the International Swaps and Derivatives Association, Inc.



Keith Noyes
Regional Director, Asia Pacific

Jacqueline Low
Senior Counsel Asia

[45] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD320.pdf.