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15 June 2007

Mr. Prashant Saran
Chief General Manager-in-Charge
Department of Banking Operations and Development
Reserve Bank of India
12th floor, Central Office Building
Shahid Bhagat Singh Marg
Mumbai – 400 001
INDIA

Dear Sir,

Draft Guidelines on Credit Default Swaps

The International Swaps and Derivatives Association, Inc. (“**ISDA**”) respectfully presents this letter of submission to the Reserve Bank of India (“**RBI**”) in relation to the Draft Guidelines on Credit Default Swaps issued by the RBI on 16 May 2007 (the “**Guidelines**”).

We were pleased to make a submission to the RBI on 22 January 2007 in relation to the draft Comprehensive Guidelines on Derivatives, and we are most grateful to the RBI for its time in considering and adopting a number of those comments. In that submission we described the membership and activities of ISDA. In short, ISDA was chartered in 1985, and today has over 790 member institutions from 54 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

ISDA, with the strong support of its membership, has been particularly active in the development of the credit derivatives market. We facilitate meetings and discussions of market practitioners in the field in a variety of jurisdictions and follow the development of the credit derivatives markets in terms of volume and product range very closely. The publication of ISDA's definitions booklets, template confirmations, standard terms matrices and settlement protocols, have all contributed to establish market standards for CDS documentation and terms and thereby ensured consistency and ultimately liquidity in the market. We also regularly engage in a dialogue with regulators in various jurisdictions to discuss the implications of a growing credit derivatives market and ways by which market growth can be facilitated at the same time ensuring that institutions active in this market are capable of handling growing volumes and an expanding product range. We look forward to further discussions with RBI in this regard.

Introduction

ISDA very much welcomes the decision to introduce credit default swaps (“**CDS**”) to the Indian financial markets, and wholeheartedly agrees that CDS and other credit derivative products meet an increasingly growing business demand in allowing an efficient means of transfer of credit risk between counterparties. As you have identified, the ability of credit derivatives to achieve these goals depends on the existence of a liquid market with as large a pool of participants as possible who are able both to buy and sell credit protection. Many of the comments in this submission have been made with this in mind.

We acknowledge also that the RBI views the Guidelines as a step on the path towards a liberalised financial market in India, and not as a final framework. We note also that the Report of the Working Group on Introduction of Credit Derivatives in India published in 2003 (the “**2003 Report**”) and the Guidelines themselves¹ identify and discuss additional forms by which credit risk can be transferred, including total return swaps, credit linked notes and collateralised debt obligations. We would view the introduction of these, and other instruments related to CDS such as indices, as highly desirable further steps towards the development of a liquid credit market in India, and we look forward to working with the RBI to expand the range of credit derivative products available in India in the future. This submission therefore does not look to expand the scope of products contemplated by the Guidelines, but instead seeks to ensure that a market in plain vanilla CDS can grow steadily to meet the needs of the financial markets in India, thereby facilitating further expansion of the credit markets in India at an appropriate time in the future. We would like to note in this regard that, globally, trading in single-name CDS accounts for only about one-third of annual CDS trading volume, with a large part of the remainder comprising trading of CDS indices.

Finally, we strongly welcome the acknowledgement and endorsement in the Guidelines of the documentation and definitions published by ISDA as the legal framework for CDS. In some areas of this submission we respectfully identify where there are discrepancies between that legal framework and the Guidelines and, where appropriate, suggest ways in which that inconsistency might be addressed. In particular the terms of the 2003 ISDA Credit Derivatives Definitions and their supplements (the “**2003 Definitions**”) form the basis for almost all credit derivative products globally, and their universal adoption by market participants has been a considerable factor in the growth of the credit derivatives market. For these reasons we make reference to the 2003 Definitions in this submission as they represent well-established market norms and, as such, continue to be instrumental in the development of a liquid credit market.

We set out below our principal comments on the Guidelines. In the annex to this letter we set out more detailed comments on the text of the Guidelines. We also enclose for your reference a copy of the 2003 Definitions.

1. The use of CDS goes beyond credit risk mitigation under Basel

We believe that the Guidelines should more clearly distinguish between those rules which are applicable to CDS generally and those additional rules which are relevant to CDS which a bank seeks to use as a credit risk mitigant in reducing its capital adequacy costs.

Whilst the Guidelines recognise the value of CDS as a means of reallocating credit risk generally, and contemplate that, in time, a wider range of counterparties might be permitted to participate, the Guidelines also seem to be focused on the use of CDS as a means for banks to reduce their capital adequacy costs by transferring the risk in respect of a specific *underlying asset/obligation*. This is indeed one important use of CDS, but it is limited in application to the banks which are bound by the capital adequacy regime and is also ultimately inconsistent with the distinction between the different

¹ For example, at paragraph 1.4.1

practices relating to trading book and banking book assets. In practice, banks buy protection under CDS for a variety of hedging needs which are not limited to capital relief.

We understand that the RBI wishes to address the use of CDS as an eligible credit risk mitigant, and that specific additional rules will apply (as they do under Basel I and Basel II) to CDS used for this purpose. Therefore we would welcome changes to the Guidelines which identify those rules which only apply to CDS which are to be used in this way, which we suggest might include the following:

(i) the entirety of paragraph 2.5, which to an extent tracks equivalent text under Basel II, is relevant only to credit risk mitigants, and we believe that this should be made more clear. We have made more detailed comments on the terms of paragraph 2.5 in the annex to this letter;

(ii) the references in paragraphs 1 and 2 to the “underlying asset/obligation”, being the particular asset held by the bank in respect of which it is attempting to reduce its capital cost. The concept of an “underlying asset/obligation” is only relevant where a bank is using the CDS as a credit risk mitigant; and

(iii) the requirements of paragraph 1.6.1, which requires that the buyer should have an underlying credit exposure.

2. The scope of counterparties

(a) Restriction to Banks and Primary Dealers

There are a number of Indian resident financial institutions which would benefit greatly from the ability to transfer credit risk under CDS, but which are outside the scope of the Guidelines by virtue of being neither banks nor primary dealers. Of these we would identify specifically Development Financial Institutions as entities with long term credit exposures and a high degree of concentration which would be likely buyers of protection.

We would also suggest that other institutions such as Non-Banking Financial Companies and All-India Financial Institutions would have a legitimate interest in buying or selling credit protection under CDS, although they may not have market-making ability. As you are aware, the broader the scope of CDS participants, the greater the liquidity of the market, which will help to achieve the RBI's objectives set out in the Guidelines.

(b) Related Parties

The Guidelines² prohibit CDS where the counterparties are related. We would suggest that this restriction can be removed. CDS can perform an important goal in allocating credit risk within a single company group for tax or accounting reasons. We also note that the concept of related parties may prevent transactions between those institutions which are directly or indirectly majority owned by the Government, which would greatly hinder the development of a CDS market.

3. The use of Reference Entities instead of Obligations

The approach of the 2003 Definitions is first to identify a Reference Entity which is the subject of the CDS, and then to identify the one or more obligations of that Reference Entity which may be used in determining whether a Credit Event has occurred and, if so, in specifying how settlement will occur (either by valuing the obligation(s) for cash settlement or by the delivery of the obligation(s) for physical settlement). These obligations may be identified specifically or generically by reference to certain Categories and Characteristics. For instance, a CDS might provide that a Credit Event could

² at paragraph 4.1.1

be triggered by a failure by the Reference Entity to make payment in respect of any of its “Borrowed Money” obligations, but only if those obligations were senior-ranking and were denominated in one of a group of specified currencies.

The advantage of this approach is that it recognises that a bank’s credit exposure to a borrower might take a number of forms (loans, letter of credits, guarantee facilities, holding of bonds), and that the bank will regularly enter into new agreements with the borrower, either to advance new funds or to refinance existing debts.

Given the objectives of the Guidelines, we strongly recommend that the RBI adopt a similar approach. This will greatly increase liquidity in the market since it will allow credit exposure to be identified by reference to the underlying borrower, and not the specific debts that it may owe to specific creditors from time to time. By contrast, if the Guidelines focus on the individual obligations of a borrower, there may be many different CDS in respect of each borrower, each of which references a particular loan agreement or bond and each of which may have little or no value if that particular debt obligation is repaid.

We recognise that the RBI wishes to impose criteria on the scope of obligations which can be the subject of a CDS, but we submit that this can be done through the use of concepts of Obligation Category and Obligation Characteristics.

4. The scope of Obligations

(a) Currency and Creditor

Some significant credit exposures of domestic entities to Indian companies arise in currencies other than Indian Rupees. These may include multi-currency term loans, guarantee and L/C facilities and liabilities under export credit guarantee facilities.

The Guidelines also state that the obligation must be owed to a resident. In some cases it may be difficult or indeed impossible to ascertain the residence of the creditor, particularly in respect of bonds, some of which may be held by Foreign Institutional Investors or Non-Resident Indians. This would risk excluding from the scope of the CDS significant credit exposures.

Given that the parties to the CDS and the Reference Entity must all be Indian resident, we suggest that this is sufficient to ensure that the CDS has a domestic subject matter, and that restrictions on the currency of an obligation and the residence of the creditor are an unnecessary and undesirable limit on the scope of CDS permitted by the Guidelines.

(b) Rating

The Guidelines require that the obligation be rated, and that the rating be maintained and published. As many obligations, notably loans, are not rated this would exclude a significant sector of domestic credit exposure from the scope of the Guidelines. This also begs the question of what happens if an obligation ceases to be rated.

It is likely that the proportion of corporate lending to borrowers with low or no ratings is likely to increase over the coming years as the Indian economy continues to grow. The ability of lenders to manage these credit exposure through CDS is likely to be a key factor in the availability of financing to such borrowers, particularly given the high capital costs under Basel II to counterparties at the lower end of the credit spectrum. We would respectfully suggest that the RBI reconsider the requirement for a rating.

If the RBI feels that a rating requirement is appropriate, we would suggest that the requirement be modified such that, at the time the CDS is entered into, the Reference Entity should have a published rating (which may be a general credit rating or a rating attached to specific obligations (i.e. bonds)), but that there should be no consequences under the CDS if that rating subsequently lapses. To aid certainty, it would be helpful also to specify that a rating agency for these purposes includes (but is not limited to) CRISIL, ICRA, CARE, S&P, Moody's, Fitch, Duff & Phelps and any of their successors and affiliates.

(c) Type of Obligation

The Guidelines refer here to tradable financial securities, fund-based credit exposure, credit risk exposure under a CDS and corporate debt securities. If the RBI were to adopt the approach we suggest in paragraph 3 above, then we believe it would be sufficient to specify that the obligation must be in respect of Borrowed Money or, if preferred, Bond or Loan (as these terms are used in the 2003 Definitions). These tend to be the categories for CDS generally.

In any event it would be helpful to specifically refer to loans as an eligible obligation and to broaden the scope of "corporate debt security" by the deletion of the word 'corporate' to recognise that the Reference Entity might be a bank, a government or municipal organisation, a statutory body, a partnership or a mutual fund. The RBI may also wish to consider whether reimbursement obligations arising from drawings under letters of credit should be a type of credit exposure on which a CDS could be written

(d) Guarantees

We recommend that the Guidelines also allow CDS to cover obligations of a Reference Entity as a guarantor of another party's obligations. Otherwise there would be no fungibility and hence no liquidity in respect of CDS on a company's direct borrowings and a CDS on the guaranteed borrowings of its finance subsidiary, whilst in practice the credit exposure may be identical.

5. The use of materiality thresholds

The prohibition on the use of materiality thresholds will inhibit the development of tranching CDS products (under which a protection seller assumes the risk of only a defined range of losses arising from credit exposures), which is one area of the credit derivatives market which has seen enormous growth over the last five years. In keeping with our hopes for further developments to liberalise the credit markets in India, we would hope that this restriction may be lifted in the near future to allow the use of credit derivatives to develop.

On a separate point, please note that the 2003 Definitions and market practice both assume that some events must be 'material' before they would constitute a Credit Event. This can be seen in the concept of a Payment Requirement (the default level is USD1,000,000 or its equivalent) for a Failure to Pay and a Default Requirement (the default level is USD10,000,000 or its equivalent) for a Restructuring. This ensures that a CDS is not triggered for minor defaults which are perhaps not indicative of fundamental credit concerns. On our reading of the Guidelines, this type of provision would not be viewed as a 'materiality threshold', and we agree that it ought not to be treated as such, but we mention it here for clarity.

6. Application of elements of the Comprehensive Guidelines on Derivatives

We acknowledge that, as a general principle, any CDS will also be subject to the Comprehensive Guidelines on Derivatives published in April 2007. However, the permitted counterparties to CDS will be significantly more limited than is the case for, say, interest rate and foreign currency derivatives, and it would be helpful to acknowledge that they are likely to all be 'market makers' rather than 'users' for the purposes of the Comprehensive Guidelines. Accordingly, some provisions of the Comprehensive Guidelines, notably paragraph 8.3 (Suitability and Appropriateness Policy), are unlikely to be applicable and we would appreciate if the RBI could confirm that paragraph 8.3 is not applicable in the current context.

7. Maturity Mismatches

We would ask that the provisions of paragraphs 4.4.5 and 4.5.3 relating to maturity mismatches be brought in line with Basel II, which specifies a minimum residual maturity of three months but which also requires that the CDS must have an original maturity of one year.

The approach to maturity mismatches under paragraph 4.8 in relation to large exposures differs from that in paragraphs 4.4.5 and 4.5.3, and gives no proportionate treatment where there is a mismatch. We would therefore suggest that the RBI consider whether there is a need to treat these provisions differently.

8. Accounting

We would also suggest that the RBI consider whether the 2006 Discussion Paper referred to in paragraph 5.1.2 contains sufficient information to be applied wholesale to CDS, or whether further guidelines would be desirable. As a general comment, we would welcome the adoption of accounting rules for derivatives (and CDS in particular) which are consistent with international accounting standards.

9. Allowing the market to set the standard terms for CDS

ISDA supports the premise that the terms of CDS should be open for negotiation by the parties to achieve their commercial objectives and, save where there is a specific regulatory purpose behind the CDS (as is the case with credit risk mitigants under Basel II), should not be prescribed. We would therefore recommend that the Guidelines do not seek to specify a particular approach which parties should take to matters such as credit events, valuation procedures or the type of obligations or entities to which CDS can apply.

This aspect of freedom of contract also allows standard terms to emerge over time from market use. The terms represent a consensus which serves all participants' interests by limiting the scope of negotiation on each CDS contract and ensuring greater liquidity in trading in CDS. They are however never mandatory, and parties remain free to agree whichever terms best fit their purpose. An example of such standard terms would be the Physical Settlement Matrix published by ISDA (most recently on 1st February, 2007 and available on our website: www.isda.org) which specifies matters such as Credit Events, Obligation Category and Obligation Characteristics which are applicable depending on the nature of the reference entity (sovereign or corporate) and the jurisdiction or geographical region in which it is incorporated.

Conclusion

ISDA would like to thank the RBI for the opportunity to comment on the proposed Guidelines and re-emphasise its positive view of the Guidelines and its support of the commitment of the RBI to developing an effective and liquid credit derivative market in India. We believe the Guidelines represent an important first step towards this goal and hope that our comments are helpful to you during your considerations.

ISDA would like to continue its dialogue with the RBI in relation to any further developments in relation to the Guidelines or to clarify any issues raised in this submission. If possible, ISDA would be extremely grateful to receive draft changes on the Guidelines when they are available and to be given a further opportunity to comment on them (as appropriate) before they are finalised.

In the meantime, if you or your colleagues have any questions regarding our comments, please do not hesitate to contact Mr David Geen (dgeen@isda.org; +44 20 3088 6222) and Mr Bay Way Yee (wyybay@isda.org; +65 6538 3879) of ISDA or Mr Paul Cluley of Allen & Overy (paul.cluley@allenoverly.com; +852 2974 7056).

Yours sincerely,

For the International Swaps and Derivatives Association, Inc.


David Geen
European General Counsel
Europe


Bay Way Yee
Director of Policy
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encl.

ANNEX

References to Pages and Sections of the Guidelines **Comments**

Section 1 - Introduction

Page 1 – Scope of Application Please refer to paragraph 2(a) (*Restrictions to Banks and Primary Dealers*) of our submission letter.

Page 4 - Section 1.3.1 Key Concepts (a) Conditions to Settlement
Under the 2003 Definitions, following the occurrence of a credit event, the **conditions to settlement** must be satisfied before settlement can be required. We suggest that where in the Guidelines references are made to settlement of the CDS after the occurrence of a credit event, a reference is added to the effect that the relevant conditions to settlement must also be met.

We suggest that the following definition of "Conditions to Settlement" could be added on page 5 of the Guidelines:

"Conditions to Settlement The conditions specified in a credit derivative contract which must be satisfied before settlement can be required. These will typically be the delivery of a credit event notice describing the relevant credit event and a notice of publicly available information which confirms the occurrence of the credit event. If the credit derivative is physically settled, the conditions to settlement will also include a notice specifying which obligation(s) will be delivered. "

(b) Credit Risk Mitigant
As mentioned in our submission letter, we suggest that the Guidelines could draw a clearer distinction between those rules which are applicable to CDS generally, and those rules which are of specific application to CDS which are to be used as a credit risk mitigant under Basel II. To assist this, we suggest that the following definition may be helpful:

"Credit Risk Mitigant A credit derivative contract which is to be used by a bank to reduce the risk weight associated with an underlying asset/obligation, and which satisfies the additional criteria set out in these Guidelines."

(c) Cross Acceleration Clause
This definition seems to be used to determine whether or not an underlying asset/obligation has a sufficient link with the reference asset/obligation cited in the CDS contract.

We would mention that the 2003 Definitions do not use the concepts of cross-acceleration and cross-default to identify whether or not a particular obligation is caught by the CDS. The concepts of Obligation Category and Obligation Characteristics define a pool of obligations, and a credit event on any of them will be sufficient to allow settlement, regardless of whether the terms of the obligations include any cross-acceleration or cross-default provisions.

If the RBI were to permit the use of Obligation Category and Characteristics as a means of defining the scope of obligations which may trigger a credit event, the definition of Cross Acceleration may become redundant. If it is still needed, then it might be amended, since a cross acceleration clause is used to trigger an event of default under a particular loan agreement between a lender and a borrower, and is not drafted to refer to a credit event under a CDS between a protection buyer and seller. We suggest perhaps the following:

**References to Pages and Comments
Sections of the
Guidelines**

"Cross-acceleration clause Recognition as an event of default under one obligation of the occurrence of a default, event of default, or some other similar condition with respect to another obligation of the reference entity which has resulted in that other obligation becoming due and payable before it would otherwise become due and payable. This would count as an event of default as if the issuer had defaulted on the first obligation."

We suggest comparable amendments to the definition and use of the term "Cross-default clause" for the same reasons.

(d) Deliverable asset/obligation

The deliverable obligation will usually be selected by protection buyer in a notice given after the credit event has occurred and will often be that which is the cheapest to deliver, rather than being specified upfront in the contract. We ask that you consider replacing the first sentence of the definition with the following to reflect this:

"A financial obligation of a single reference entity which is uniquely specified in a credit derivative contract or by the protection buyer pursuant to a credit derivative contract after a credit event occurs, that will be delivered by the protection buyer in return for the credit event payment by the protection seller."

In addition, could RBI please clarify what is meant by 'identical' here for the purposes of (a) the nature of an obligation and (b) its maturity. With regard to maturity, the Guidelines already provide detailed guidance on maturity mismatches, so it would not seem appropriate to include 'identical maturity' as a general condition here.

With regards to the next sentence which starts with "A deliverable asset/obligation shall have the same obligor...", as mentioned in Paragraph 3 (*The use of Reference Entities instead of Obligations*) of our submission, we believe that the reference to underlying obligation is only relevant to CDS used as credit risk mitigants for the purposes of capital adequacy. Also, the criteria affecting deliverable obligations are specified in the operative terms of the Guidelines, and it is perhaps unhelpful to paraphrase them in the definitions. Accordingly we would ask if you could consider deleting this sentence, or perhaps replacing it with "A deliverable asset/obligation shall satisfy the criteria specified in the contract and, if the contract is intended to be a credit risk mitigant, the additional criteria specified for such purposes in these Guidelines".

(e) Materiality Threshold

The last two sentences dealing with materiality could perhaps be deleted because in practice, materiality is not determined in these ways.

(f) Premium

We recommend that the words "upfront or periodic" be inserted before the word "fee". Please also mention that the Premium is also commonly referred to as the Fixed Amount.

(g) Reference asset/obligation

We refer to our comments on Paragraph 3 (*The use of Reference Entities instead of Obligations*) of our submission letter and the discussion of Obligation Category and Characteristics. The definition of Reference asset/obligation could be amended to encompass this by the following:

"Reference asset/obligation One or more financial obligations of, or

References to Pages and Sections of the Guidelines **Comments**

guaranteed by, a single reference entity which may trigger a credit event and which may be uniquely specified in a credit derivative contract or specified by reference to particular categories and characteristics in the contract. It is usually a security, but could also be a loan or other borrowed money obligation, including reimbursement obligations in respect of letters of credit. It may also provide a basis for cash settlement or define the seniority of deliverable obligations for physical settlement where applicable."

(h) Reference entity

The Guidelines require that the reference entity be a "single legal entity". We would be grateful if you could clarify that this would not exclude other entities such as partnerships, government, municipalities and mutual funds, as many significant borrowers in India adopt these legal forms

(i) Underlying asset/obligation

Consistent with our comments on Paragraph 1 (*The use of CDS goes beyond credit risk mitigation under Basel*) of our submission letter, please consider limiting the application of this definition to "credit risk mitigants", as we have suggested defining this term above. Please also consider revising the final sentence so that the underlying asset may be an obligation of, or guaranteed by, the relevant obligor.

Page 7 - Section 1.4.2(b) Consistent with our comments in Paragraphs 1 (*The use of CDS goes beyond credit risk mitigation under Basel*) and 4(d) (*Guarantee*) of our submission letter, please consider replacing the paragraph with the following:

"the reference entity shall be the obligor for, or the guarantor of, the reference asset/obligation and the deliverable asset/ obligation (and, in the case of a credit risk mitigant, the underlying asset/ obligation). "

Page 8 – Section 1.4.2(d) Please consider deleting this condition for the reasons set out in Paragraph 4(a) (*Currency and Creditor*) of our submission letter.

Page 8 – Section 1.4.2(f) '*tradable financial security*'

For the sake of clarity and certainty, we think it would be helpful to define financial security in the same way as 'Bond' in the 2003 Definitions, namely as an obligation in the nature of borrowed money in the form of a debt security. We would also ask the RBI to consider the need and meaning of the word 'tradable'. It is not clear what is meant by 'tradable' and why it should affect whether parties can buy and sell protection on such a security.

'fund-based credit exposure'

Again, for certainty, it would be extremely helpful to state that this concept will encompass a loan, reimbursement obligations under letters of credit and other obligations in respect of borrowed money.

"or a credit risk exposure to a reference entity assumed by a protection seller in a CDS contract"

If the RBI were to adopt the concept of Obligation Category and Characteristics then we believe this wording is not needed. A bank which is seeking to hedge its exposure under a CDS where it has sold protection will still refer to the Obligation Category and Characteristics of the Reference Entity on which it has sold protection, and not to the particular CDS under which the bank's exposure arises. Please refer to Paragraph 4(c) (*Type of Obligation*) of our submission letter.

Page 8 – Section 1.4.2(g) Please consider amending this condition to the following:

References to Pages and Sections of the Guidelines **Comments**

"in the case of a credit risk mitigant, the reference asset/ obligation(s) shall either include the underlying asset / obligation or include other obligations which have at least the same seniority;"

We suggest the deletion of the reference to an 'identical' nature and 'maturity' for the reasons set out in our comments above with respect to the definition of "Deliverable asset/obligation" in section 1.3.1 of the Guidelines. Paragraph 4 of these Guidelines specifically permits and addresses maturity mismatch, yet this wording would prohibit it.

Page 8 – Section 1.4.2(h) We assume that this restriction should only be relevant to physically settled CDS. Under the 2003 Definitions, a seller can specify a third party to accept delivery, which can allow settlement to occur even if the seller would not itself be able to hold the deliverable obligation. Also, we should make it clear that a breach of this principle does not invalidate the contract, since buyer may have no means of knowing whether seller is subject to such a restriction and will have otherwise paid a premium for protection it cannot use.

Accordingly, we would prefer this restriction to be deleted. If that is not acceptable, then we ask if you would consider the insertion of the words "physically settled" before "credit derivatives" and the following words at the end of the sentence: ", although this will not affect the ability of the protection buyer to enforce the contract."

Page 8 – Section 1.4.3 Please refer to paragraph 4(b) (*Rating*) of our submission letter and kindly consider our request for the deletion, failing which the amendment, of this requirement.

Page 9 – Section 1.6.1 We refer to the second bullet point relating to the protection buyer. Consistent with our comments on Paragraph 1 (*The use of CDS goes beyond credit risk mitigation under Basel*) of our submission letter, we believe that the requirement that the protection buyer must have an underlying credit risk exposure in the form of permissible underlying asset/obligation should only apply in respect of credit risk mitigants.

Section 2 – Product Requirements

Page 9 – Section 2.1.1 In keeping with our submission in paragraph 3 (*The use of Reference Entities instead of Obligations*) of our submission letter, please consider replacing the words "reference assets" with "reference entities" and adding "or their obligations" at the end of the first sentence.

As we have mentioned in our submission letter, CDS are typically specific to the reference entity. The parties to the CDS then define the scope of obligations which can trigger a credit event by the use of Obligation Category and Obligation Characteristics.

Page 10 – Section 2.1.2 For both of the bullet points, we suggest that the words "(in the case of a credit risk mitigant)" are added before the words "the protection buyer has a credit risk exposure".

Page 12 - Section 2.3.1 We refer to the last sentence of this section. Given that the only CDS permitted are between Indian residents, we wonder if there is any need to contemplate other jurisdictions?

Page 12 – Section 2.4.2 We would like to mention that Bankruptcy and Failure to pay are generally universally applied to corporate reference entities, with Restructuring commonly used as a third credit event.

Page 13 – Section 2.5 We note how this section broadly tracks similar criteria as set out in the Basel II Framework in recognising CDS to be used as a credit risk mitigant in reducing

**References to Pages and Comments
Sections of the
Guidelines**

capital adequacy costs. To clarify the RBI's intentions here, we suggest that the words "The provisions of this paragraph 2.5 apply to CDS which are intended to be recognised as credit risk mitigants for the purposes of Paragraph 4 of these Guidelines" be added at the start of this paragraph.

The remainder of our comments on this Section 2.5 are identifying where the equivalent Basel II wording differs from the Guidelines. In each case, we believe it would be most beneficial to amend the Guidelines to conform with the international norms set out in the Basel II framework.

- (a) in Section 2.5.1(i) the words "other than where the protection buyer defaults in paying the premium" be added following the sentence "The contract must be irrevocable";
- (b) Section 2.5.1(iii) does not have an equivalent in Basel II, and in practice a seller can have recourse to a buyer if there is a breach by buyer of any representations or other terms of the contract. For these reasons, we would ask if the RBI could please consider deleting this requirement;
- (c) in Section 2.5.1(iv), by requiring that the credit events contain as wide a range of triggers as possible, the Guidelines differ from Basel II and will cover credit events which are not market standard. Many of the credit events overlap (for instance a Failure to Pay will almost certainly also constitute an Obligation Default and is likely also to lead to an Obligation Acceleration) which is why the market adopts a selective approach, specifying only those credit events which are deemed necessary to cover adequately the key credit risks. Requiring the use of all credit events may well limit the availability of CDS and raise the cost of protection for buyers, without providing them with any additional cover.

The list of minimum credit events is consistent with Basel II, save to the extent that it does not contemplate any partial recognition for CDS which exclude Restructuring as a credit event.

We would strongly recommend that this paragraph be made consistent with the equivalent provisions of Basel II;

- (d) in Section 2.5.1(v), it would be helpful if this were to specify that it only applies to cash settled CDS. Consistent with our comments in Paragraph 9 (*Allowing the market to set the standard terms for CDS*) of our submission letter, we would ask that the prescribed 30-day maximum period for valuations be deleted. This is in practice a relatively short time, and it is in the interests of both buyer and seller to ensure that the valuations occur at a time when there are likely to be fair quotations available from dealers. This may require different valuation arrangements for different reference entities, and may be a function of the liquidity of CDS on a particular reference entity. As such, the protection buyer and seller will have a legitimate interest in negotiating this at the time they enter into the contract, rather than having a maximum period imposed on them;
- (e) in Section 2.5.1(vi), as the intention is for the CDS to be between Indian residents only, we wonder if it is necessary to extend to all jurisdictions (we also note that this does not appear to be covered in the Basel II Framework);
- (f) with respect to Section 2.5.1(vii), we agree that the protection buyer should be able to demonstrate that the underlying asset/obligation is within the scope of the reference obligations covered by the CDS (such that a default

References to Pages and Sections of the Guidelines **Comments**

on the underlying asset will entitle the protection buyer to claim settlement). However, as mentioned above in our comments on the definitions, we do not feel that it is necessary to make reference to cross-default or cross-acceleration clauses. Also, this paragraph seems to duplicate section 2.5.1(xiii). For these reasons, we would ask the RBI to please consider deleting this requirement;

- (g) Section 2.5.1(viii) and Section 2.5.1(ix) appear to be more onerous than those set out in the Basel Framework. We would therefore be grateful if sub-paragraph (viii) could be replaced with the following words to be in line with Basel II: "in respect of a physically settled CDS, if the protection buyer's right/ability to transfer the underlying obligation to the protection seller is required for settlement, the terms of the underlying obligation must provide that any required consent to such transfer may not be unreasonably withheld", and if sub-paragraph (ix) could be deleted. Also, with regard to Section 2.5.1(ix), the Guidelines should recognise that it is not practical to obtain consents to transfer at the time of entry into a CDS, and any such a requirement would have a very damaging effect on the relationship between a bank (as protection buyer) and its customer (as reference entity), which would seriously and adversely affect the bank's willingness to manage its credit exposure in the way which the Guidelines seek to encourage;
- (h) with regard to Section 2.5.1(xi), kindly consider amending the first sentence to reflect the fact that maturity mismatches are specifically permitted and addressed in Section 4 (whereas this sentence operates as an absolute prohibition on maturity mismatch). The second sentence of Section 2.5.1(xi) does not appear in Basel II and it would be helpful if it could be clarified, perhaps as "the grace period applicable to any credit event triggered by a failure to pay should not be longer than the grace period agreed upon under the loan agreement", although the standard provisions of the 2003 Definitions allow a minimum 3 business day grace period for these purposes even where the underlying obligation has no grace period at all;
- (h) in Section 2.5.1(xiii), consistent with our comments in Paragraph 4(d) (*Guarantees*) of our submission letter, we would ask for an amendment such that the reference and underlying assets/obligations can be issued or guaranteed by the same obligor.

Page 13 – Section 2.5.1 Kindly note that Basel II provides for the possibility of the protection seller being entitled to terminate the contract, subject to a corresponding adjustment to the value of such a CDS as a credit risk mitigant. This provision however prohibits any such termination provision. Please consider conforming this paragraph to the approach taken by Basel II.

Section 1.6, Section 2.1, Section 2.2, Section 2.4 and Section 2.5 Please consider our comments in paragraph 9 (*Allowing the market to set the standard terms for CDS*) of our submission letter.

Section 3 - Risk Management

Page 15 - Section 3.1.1 and 3.1.8 Please see our comments in paragraph 6 (*Application of elements of the Comprehensive Guidelines on Derivatives*) in our submission letter. It would be helpful if the professional nature of the CDS participants, and the corresponding effect on the application of the Comprehensive Guidelines, could be noted here. On this basis, with respect to Section 3.1.8, please consider that the bank would not

References to Pages and Sections of the Guidelines **Comments**

have to apply the appropriateness and suitability policy in its dealing with the counterparty in the current circumstances.

Page 17 - Section 3.2.1 (v), Section 3.4.1(viii) Could the RBI please clarify the reference to underlying borrower? We wonder if this should be a reference to the protection seller. If the bank is a protection buyer, then its primary credit exposure is to the protection seller. If the bank is the protection seller and the CDS is physically settled, then it will not have any residual claim against the underlying borrower (as it will have delivered it to the protection seller).

Page 18 - Section 3.4.1(i), Section 3.4.1(iii) As mentioned in our submission, the counterparties are likely to be market makers for the purposes of the Comprehensive Guidelines, in which case the bank would not have to apply the appropriateness and suitability policy in its dealing with the counterparty.

Section 4 – Prudential Norms

Page 19 – Section 4.1.1 Please see our comments in Paragraph 2(b) (*Related Parties*) of our submission letter.

Page 20 - Section 4.4.1 The amount of credit protection that is to be paid, usually determined by reference to the notional amount, may need clarification. On a cash settled CDS the credit event payment will not be known until the market value of the reference obligation has been determined, although the CDS will still act as a hedge of the underlying asset/obligation provided that the notional amount of the CDS is at least equal to the protection buyer's exposure to the underlying asset.

Page 21 - Sections 4.4.5 and 4.5.3 We note that under the Basel II guidelines, the minimum residual maturity requirement is set at three months and there is an additional requirement that the CDS have an original maturity of one year or more. We would welcome a change to bring the Guidelines in line with Basel II.

Page 24 – Section 4.7 There is an important divergence from Basel II here because the Guidelines do not reflect the provisions of the *comprehensive approach* under Basel II which can allow a 100% offset, and which is the mandatory approach for positions in the trading book, subject to haircuts. This is very important for the ability of banks to be willing to quote prices for CDS and achieve liquidity in the market. Please consider bringing the Guidelines to be in line with Basel II.