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**BY POST AND BY E-MAIL**

7 November 2007

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

Dear Sir,

**Revised Draft Guidelines on Credit Default Swaps**

The International Swaps and Derivatives Association, Inc. (“**ISDA**”) respectfully presents this further letter of submission to the Reserve Bank of India (“**RBI**”) in relation to the revised Draft Guidelines on Credit Default Swaps issued by the RBI on 24 October 2007 (the “**Revised Guidelines**”).

**Our Original Submission**

We were pleased to make a submission to the RBI on 15 June 2007 in relation to the initial draft of the guidelines, and we were very grateful to the RBI for their time in attending a meeting with ISDA representatives in Mumbai on 29 June 2007 to discuss the original submission.

**Principal comments on Revised Guidelines**

We welcome the introduction of the new paragraph 5 which makes it clear that the eligibility criteria are applicable only to the extent that a CDS contract is intended to be used as a credit risk mitigant, and are not conditions which will apply to all credit derivatives.

We also welcome the changes to the treatment of maturity mismatches and the removal of the prohibition on credit derivatives with a materiality threshold, and are grateful to the RBI for considering our submissions in these regards.

We fully support the RBI's objective of promoting a healthy credit derivative market in India and allowing a means for efficient transfer of credit risk between sophisticated counterparties. In our

opinion, two of the essential features of a healthy market are liquidity (the ease with which participants can buy and sell) and depth (the range of obligations on which credit protection can be written). We therefore wish to particularly highlight below our concerns on two aspects of the Revised Guidelines which we feel may operate to reduce substantially the liquidity and depth of the credit derivatives market and thereby hinder its healthy development.

(i) ***Liquidity of the market – the requirement that Buyer have a Credit Risk Exposure***

Under paragraph 1.6.1, we note that a protection buyer is required to have a credit risk exposure, either by way of an actual credit or a sold position in a CDS. This requirement will effectively prevent participants from undertaking market making activities in CDS since it will be much harder for participants to quote prices on both the buy and sell sides of the market. It will therefore operate to remove a primary source of liquidity, and have an adverse impact on the transparency of pricing.

Another restriction on market making arises under paragraph 3.1.3, since it is unrealistic to expect Seller to undertake a detailed credit assessment to be made on a reference entity in these situations.

Our members have expressed serious concerns as to the ability of the market to achieve the RBI's objectives if normal market making is curtailed in this way. We respectfully ask that these requirements be removed, or at least that some carve-out is added with respect to institutions who are willing to act as market makers.

(ii) ***Depth of the market – the requirement that obligations be rated***

Our members have advised that, relative to the principal amount of credit exposure held by banks in India, the proportion of rated obligations is very low. The proportion of fund based credit exposure (i.e. loans) with ratings is even lower. Moreover, where a rating is ascribed to a loan, it is often done on a private basis, and would not be published.

The effect of this is that the universe of obligations which will satisfy the criteria in paragraph 1.4.3 of the Revised Guidelines may be, relatively speaking, very small. Given the volume of bank credit exposures in the form of loans, this provision may have the effect of greatly limiting the ability of commercial banks to use CDS to manage their exposures, which would seem to go against the spirit and objective of the guidelines, and greatly hinder the healthy development of the market. We mentioned in our original submission that a rating is more commonly applicable to an entity rather than a specific obligation, and we respectfully repeat our suggestion that this may be a more suitable way to incorporate a rating requirement into the guidelines.

It is also not clear what should happen if a rating is lost during the life of a CDS transaction, since this will be out of the control of both parties, and whether elements (c) and (d) in paragraph 1.4.3 add to the general requirement that the rating be current. We would ask that it be made clear that there are no adverse consequences on an existing CDS if, after the CDS is executed, the rating ceases to satisfy the criteria in paragraph 1.4.3.

**Additional comments on the Revised Guidelines**

We do not propose to set out again all of the matters raised in our original submission, but we would restate our conviction in the views which we expressed, and respectfully encourage the RBI to reconsider those elements which are not reflected in the Revised Guidelines.

We would however make the following specific comments.

(i) *Accounting Treatment upon the occurrence of a Credit Event*

We are concerned that paragraph 4.9.2 may cause substantial and unnecessary fluctuations in P&L accounts by requiring recognition of a 'worst case' position from the date of the credit event, which is then corrected once settlement occurs. We suggest that, on the event determination date for the credit event, Seller should recognise a liability to Buyer in an amount equal to its best estimate of the settlement amount. As to paragraph 4.9.1, we do not understand why Buyer should disregard the CDS protection from the event determination date until settlement occurs, since at that point Seller's liability will have crystallised (even if not yet quantified).

(ii) *Systems and Controls*

We previously mentioned that some elements of the Comprehensive Guidelines will in practice not be applicable to CDS as currently contemplated because a bank or primary dealer is unlikely to constitute a 'user' for those purposes. With this in mind, we would ask that paragraph 3.4(iii) of the Revised Guidelines be deleted as it would be very onerous for any counterparty to satisfy, and seems to go beyond even the Suitability and Appropriateness requirements under paragraph 8.3 of the Comprehensive Guidelines (which would seem not to apply at all to a transaction between banks or primary dealers). In the international market, each party takes responsibility for its own compliance with applicable laws and regulations, and gives a corresponding representation to the counterparty.

(iii) *Exposure Norms*

We do not understand why the treatment of maturity mismatch in respect of CDS as a credit risk mitigant for an exposure to a specific reference obligation should also apply to CDS in the operation of exposure norms, and accordingly the calculation of overall single borrowing limits (see paragraph 4.7.1). We would accordingly ask that paragraph 4.7.1 be amended.

(iv) *Guarantees*

Consistent with our comment above on the importance of the depth of the market, we think it would be beneficial if the scope of CDS were extended to cover guarantee obligations, with the understanding that in such situations the guarantor (rather than the underlying obligor or underlying obligation) should satisfy the rating requirements imposed under paragraph 1.4.3.

(v) *Reference to ISDA and its definitions*

The name of our organisation is mis-stated in the Revised Guidelines. Would it be possible to restate paragraph 1.3.1 to read:

"The meaning of various terms used in these guidelines is as in the 2003 Credit Derivatives Definitions (and related supplements and other documents) published by the International Swaps and Derivatives Association, Inc. ("ISDA")."

(vi) *Protection Buyer - Sold Position*

We would be very grateful if the RBI could kindly clarify the statement in paragraph 1.4.2 that "PDs can also have underlying positions as a sold protection"? It is not clear if this adds to the general statement in paragraph 1.6.1 that a Buyer's credit risk exposure may include a sold position under a CDS.

(vii) *Capital Adequacy for Protection Buyer*

We note that paragraph 4.5 (Capital adequacy for Protection Buyer) in the original draft has been deleted. ISDA would appreciate if the RBI could confirm whether this section should be re-inserted.

(viii) *Paragraph reference in Paragraph 4.5*

Under paragraph 4.5.3, we believe that the reference to the paragraph dealing with capital adequacy treatment should be to paragraph 4.6 instead.

**Conclusion**

ISDA would like to thank the RBI for the opportunity to comment on the Revised Guidelines and re-emphasise its positive view of the Revised Guidelines, and its support of the commitment of the RBI to developing an effective and liquid credit derivative market in India. We hope that our comments are helpful to you during your considerations.

As we mentioned at our meeting on 29 June, 2007, ISDA would like to continue its dialogue with the RBI in relation to any further developments in relation to the guidelines, to clarify any issues raised in this submission or generally to discuss any future regulatory developments in the derivatives market in India. 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](mailto:dgeen@isda.org); +44 20 3088 6222) and Mr Bay Way Yee ([wyybay@isda.org](mailto:wyybay@isda.org); +65 6538 3879) of ISDA or Mr Paul Cluley of Allen & Overy ([paul.cluley@allenoverly.com](mailto:paul.cluley@allenoverly.com); +852 2974 7056).

Yours faithfully,

**For the International Swaps and Derivatives Association, Inc.**



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