DRAFT GUIDELINES OF RBI ON CREDIT DEFAULT SWAP

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Reserve Bank of India (RBI) has come out with draft guidelines on Credit Default Swap (CDS) per notification dated May 2007. The guidelines could not have come at a more opportune time, as several players are waiting eagerly to get appropriate instruments to manage credit risk in their portfolio.

The guidelines initially are addressed to commercial banks and primary dealers only and the scope is limited to usage of Credit Default Swap by the banks and primary dealers for sale and purchase of credit protection in respect of single resident reference entity. Down the line, it seems that insurance companies and mutual funds also would get to participate in the exciting field of credit derivatives.

For the uninitiated, credit derivatives are synthetic instruments for transfer of credit risk in a financial transaction or a portfolio consisting of financial assets. Most commonly used form of credit risk transfer that we in India are conversant with, is securitization. Securitization has focus on selling assets with credit risk. Banks can sell their loans directly or they can securitize. or pool together their assets with credit risk and sell parts of the pool to outside investors. Either way it reduces credit risk because the credit exposure is transferred to the new owner. Unfortunately, these methods are insufficient for managing the credit exposure of many financial institutions.

Credit derivatives are financial contracts that provide insurance against credit-related losses. These contracts give investors, debt issuers, and banks new techniques for managing credit risk that complement the loan sales and asset securitization methods.

A credit derivative is usually a bilaterally entered contract. The value of the contract is derived from the credit risk of the underlying like a bond, a bank loan, or some other credit instrument. The value of a credit derivative is linked to the change in credit quality of these instruments. Different variants of credit derivatives are Credit Default Swap, Total Return Swap, Credit Linked Notes, Collateralized Debt / Loan Obligations (CDO/CLO), both index tranched and bespoke, Credit Spread Options etc. CDOs on CDOs or CDO2 are new variants of credit derivatives.

Since most of these are well known to most of the discerning readers, we are dwelling on the draft guidelines of Reserve Bank of India and are submitting observations hereunder as to what according to us are required to be additionally addressed to make the world of credit derivatives in India more meaningful and in line with the expectation of the market:

1. At the very beginning we draw attention to a statement in the draft that declares that the document does not supersede any previous guidelines. While this is partially true, a clearer statement on why the draft guidelines of 2003 are not pursued to logical end could have put things in proper perspective.
2. It is not also understood as to why the scope is kept limited to Banks and PDs and that too in respect of single resident reference entity, leaving other financial institutions and retail assets outside the purview. At a time when infrastructure development through public private partnership is encouraged and deepening and widening of debt market is spoken about, the option is required to be extended to other financial institutions as well including but not limited to registered NBFCs and institutions dedicated to infrastructure financing in particular.
3. It is the experience of the undersigned that Public Sector Banks with overseas presence write protections freely in respect of Credit Linked Notes referencing to FCCBs issued by Indian corporates in the international market. It is not clear whether the Banks will continue to be permitted to write such protections in the international market but not in the domestic market.
4. We expected RBI to appreciate the problems of NBFCs more closely and to appreciate that not all NBFCs that are in the business of creation of physical assets in the country are doing so for narrow business gains. Some of them are in the business to address the gap in the physical infrastructure of the country that deters foreign investments to come in. Unfortunately they are in the finishing segment of the infrastructure vertical and are not yet officially recognized as infrastructure activities.
5. It is well known that the NBFCs, particularly Asset Finance Companies run huge asset liability mismatches in their books in the absence of alternative source of funding other than credit lines from Banks. In order to address this issue they normally enter in to bilateral deals for sale of assets or undertake vanilla securitization. Recent guidelines of RBI indirectly restricting flow of credit to NBFC ND SI have further put such NBFCs in a spot as assets they finance are

funded at a much cheaper rate in the market than the rate at which they can raise resources from Banks.

6. In the absence of variety of players interested in loans proposed to be sold / securitized, the counter parties are almost always banks only. Availability of CDS to NBFCs would have afforded some alternatives (CDOs in particular) to them to go for tranched securitization and sell them to different players according to the risk appetite / comfort level. CDOs take a debt portfolio and partition the credit risk to suit different investors' demands. This is done by placing a basket of bonds into an SPV, and issuing a series of notes against the basket, which consecutively bears the losses on the portfolio. The arrival of the credit default swap has enabled product structurers to replicate cash CDO portfolios without actually using the underlying debt – the synthetic CDO.
7. From the point of view of regulatory oversight also RBI would rather like to encourage securitization / CDOs than continuing with popular bilateral deals where isolation of assets from the seller (true sale) and establishing bankruptcy remoteness of seller (putting the beneficial cash flow from the sold assets beyond the reach of the transferor, or any consolidated affiliate of the transferor, and their creditors either by a single transaction or a series of transactions taken as a whole even in the event of bankruptcy or receivership of the transferor or any consolidated affiliate), appear at times to be extremely difficult and tend to vary from one legal expert to another. Besides, tranched securitization will attract many players in to the debt market thereby lending solidity to its process of maturity.
8. As far as the institutional mechanism to facilitate credit derivative transaction is concerned, RBI has stopped short of announcing the initiatives they are required to take. In order to make credit derivatives attractive, it is important that indices like the CDX and iTraxx indices are launched to serve as true benchmarks in credit trading. Constructed as baskets of a sample of single-name default swaps with standardized maturity dates and coupons, they instantly give the market the liquidity it needs. Understandably Indian market does not have adequate data to build such indices. However, our Rating Agencies are eminently competent to provide a solution for this going forward and a role for them should be defined in the guidelines.
9. RBI may also contemplate identification and approval of select legal firms to undertake legal due diligence and sign off on all contracts that represent transfer of credit risk whether through securitization / loan sales route or through credit derivatives. At a time when Indian economy is getting integrated

and transnational are evincing interests in the Indian market, such calibration of the institutional mechanism is felt to be essential prerequisite. In this context it may be stated that though the guidelines have referred to ISDA Master Agreement, contemporary literature suggests that the ISDA is not to be taken as an omnibus solution. According to Mr. Joris Vlug of Zanders & Partners, "In a more 'volatile' world it is sensible and strongly recommended to thoroughly negotiate ISDA schedules. At least two main items in the schedule should receive special attention. One is the fact that the parties (especially corporates) tend to forget that a trigger for a termination event in an ISDA schedule automatically triggers other funding facilities through the cross default sections in those funding facilities. The second concern is the tendency of banks to propose a schedule, which is not realistic from the other party's point of view, either due to stringent covenants or unrealistic terms and conditions. Remember one important thing: an ISDA Agreement is a bilateral agreement, so you must negotiate thoroughly." Select legal firms may give necessary consultancy in this context and enable deals to go through without any doubt about their enforceability, particularly when the concept of 'restructuring', 'modified restructuring' and 'modified modified restructuring' as default events create some doubts / haziness.

10. Besides, taking a cue from SOX (Sarbanes Oxley) compliance requirements, RBI might as well obligate entities using credit derivatives to induct in their Audit Committees with at least one independent financial expert who is conversant with derivatives and derivative accounting. Such members along with others in the Audit Committee, may be requested to examine internal controls at a desired level of detail (e.g., about the structure of derivatives, the risks they hedge, the model used for their mark-to-market, their hedge effectiveness over time, the management and procedural controls between the front and back offices, and the conformance with trading policies and limits etc). It is stated "treasurers who are infrequent users of derivatives may not have adequate systems, controls and processes in place. They may also be unaware of the leverage implicit in the transactions, and could end up with transactions that have a huge negative impact on their financial statements. The identified expert in the Audit Committee should develop a statement that specifies what hedging techniques and instruments should be used to support strategy. This involves detailed descriptions of the risk appetite, forecasted transactions, partial term hedges and other issues. Without it the risk policy is often left to the whims of treasury officials, who could pursue policies that are at odds with the board's wishes."

11. RBI has rightly prescribed that banks should address issues regarding conflicts of interest while structuring CDS. For that matter it is equally important for securitization and other credit derivatives too. Like in treasury operations, the concept of middle office is equally important in credit derivative transactions. In this context the prescription given by Mr. Joel Bessis in the following statement is worth recalling: " Even though banks have always followed well-known diversification principles, classical emphasis of credit analysis is at the transaction level. Portfolio analysis that has significant potential to improve risk return trade off calls for *separation of origination from portfolio management*."
12. Lastly, given the fact that process automation in different banks and PDs are at different levels of maturity, giving across the board authority level to write protection might not be free from risks. The more comprehensive the process automation is the lesser is the degree of operational risk. Hence a benchmark requirement of process automation could have been made mandatory for writing derivative contracts.

While concluding, we draw attention to the recommendations of the Joint Forum of Basel Committee on Banking Supervision (BCBS) on the issue of Credit Risk Transfer (CRT) in October 2004. BCBS proposes that any CRT / player in CRT space should satisfy the following tests:

1. Whether the instruments/transactions accomplish a clean risk transfer,
2. The degree to which CRT market participants understand the risks involved, and
3. Whether CRT activities are leading to undue concentrations of credit risk inside or outside the regulated financial sector.

It has also been stated, "some transactions are not really intended to transfer a large portion of credit risk in the first place. For example, some structured transactions may only transfer the "catastrophic" risks associated with the most extreme set of portfolio outcomes; these risks may be more macroeconomic than credit events. It is therefore important that all participants have a good understanding of the relevant transactions and the circumstances in which they do and do not transfer credit risk."