RESERVE BANK OF INDIA
FINANCIAL MARKETS REGULATION DEPARTMENT
9TH FLOOR, CENTRAL OFFICE BUILDING, FORT
MUMBAI 400 001

Reserve Bank of India (Credit Derivatives) Directions, 2021 – Draft

In exercise of the powers conferred under section 45W of the Reserve Bank of India Act, 1934 (hereinafter called the Act) read with section 45U of the Act and in supersession of Circular No. IDMD.PCD.No.10/14.03.04/2012-13 dated January 07, 2013, the Reserve Bank of India (hereinafter called the Reserve Bank) hereby issues the following Directions.

1. Short title, scope and commencement of the Directions

(i) These Directions shall be called the Reserve Bank of India (Credit Derivatives) Directions, 2021.
(ii) These Directions shall come into force with effect from <*a specified date*>.
(iii) These Directions shall apply to credit derivatives transactions undertaken in Over-the-Counter (OTC) markets and on recognized stock exchanges in India.

2. Definitions

In these Directions, unless the context otherwise requires:

(i) **Cash settlement** of CDS means a settlement process in which the protection seller pays to the protection buyer, an amount equivalent to the loss in value of the reference obligation.
(ii) **Credit derivative** means a derivative contract whose value is derived from the credit risk of an underlying debt instrument.
(iii) **Credit Default Swap (CDS)** means a credit derivative contract in which one counterparty (protection seller) commits to compensate the other counterparty (protection buyer) for the loss in the value of an underlying debt instrument resulting from a credit event with respect to a reference entity and in return, the protection buyer makes periodic payments (premium) to the protection seller until the maturity of the contract or the credit event, whichever is earlier.

(iv) **Credit event** means a pre-defined event related to a negative change/ deterioration in the credit worthiness of the reference entity underlying a credit derivative contract, which triggers a settlement under the contract.

(v) **Deliverable obligation** means a debt instrument issued by the reference entity that the protection buyer can deliver to the protection seller in a physically settled CDS contract, in case of occurrence of a credit event. The deliverable obligation may or may not be the same as the reference obligation.

(vi) **Electronic Trading Platform (ETP)** shall have the same meaning as assigned to it in paragraph 2(1) (iii) of the Electronic Trading Platforms (Reserve Bank) Directions, 2018 dated October 05, 2018, as modified from time to time.

(vii) **Exchange** shall mean 'recognised stock exchange' and shall have the same meaning as assigned to in Section 2 (f) of the Securities Contract Regulation Act, 1956.

(viii) **Hedging** means the activity of undertaking a derivative transaction to reduce credit risk of a particular debt instrument or a portfolio of debt instruments.

(ix) **Infrastructure company** means a company engaged in specific infrastructure sub-sectors as mentioned under the Harmonized Master List of Infrastructure Sub-sectors notified by Department of Economic Affairs, Ministry of Finance, Government of India, via gazette notification no. F.No.13/6/2009-INF dated April 08, 2016, as amended from time to time.

(x) **Market-makers** mean entities which can buy and sell protection from/to users and other market-makers in order to provide liquidity to the market.

(xi) **Net worth** shall have the same meaning as assigned to it in Section 2(57) of the Companies Act, 2013 (as amended).

(xii) **A Non-resident** means and includes a 'person resident outside India' as defined in section 2 (w) of Foreign Exchange Management Act, 1999 (42 of 1999).

(xiii) **Over-the-Counter (OTC) markets** mean markets where derivative transactions are undertaken in any manner other than on exchanges and shall include electronic trading platforms (ETPs).

(xiv) **A Person resident in India** shall have the same meaning as assigned to it in Section 2 (v) of the Foreign Exchange Management Act, 1999.

(xv) **Physical settlement** of CDS means a settlement process in which the protection buyer transfers any of the eligible deliverable obligations to the protection seller against the receipt of notional/face value of the deliverable obligation.

(xvi) **Reference entity** means a legal entity, against whose credit risk, a credit derivative contract is entered into.

(xvii) **Reference obligation** means a debt instrument issued by the reference entity and specified in a CDS contract for the purpose of valuation of the contract and for determining the cash settlement value or the deliverable obligation in case of occurrence of a credit event.

(xviii) **Related parties** shall have the same meaning as assigned to it under paragraph 9 of Indian Accounting Standards (IndAS) 24: Related Party Disclosures.

(xix) **Single-name CDS** means a CDS contract in which the underlying is a single reference entity.

(xx) **Users** mean persons that undertake derivative transactions other than as a market-maker.

(xxi) Words and expressions used but not defined in these Directions shall have the same meaning as assigned to them in the Reserve Bank of India Act, 1934.

3. Eligible participants

The following persons shall be eligible to participate in credit derivatives market:

(i) A person resident in India;

(ii) A non-resident, to the extent specified in these Directions.

4. Permitted products in OTC market

(i) Market-makers and users may undertake transactions in single-name CDS contracts.

(ii) Market-makers and users shall not deal in any structured financial product with a credit derivative as one of the components or as an underlying.

5. Reference Entities and Obligations for CDS

(i) The reference entity in a CDS contract shall be a resident legal entity who is eligible to issue any of the debt instruments mentioned under paragraph 5(ii).

(ii) The following debt instruments shall be eligible to be a reference / deliverable obligation in a CDS contract:

a. Commercial Papers, Certificates of Deposit and Non-Convertible Debentures of original maturity upto one year;

b. Rated INR corporate bonds (listed and unlisted); and

c. Unrated INR bonds issued by the Special Purpose Vehicles set up by infrastructure companies.

(iii) The reference/deliverable obligations shall be in dematerialised form only.

(iv) Asset-backed securities/mortgage-backed securities and structured obligations such as credit enhanced/guaranteed bonds, convertible bonds, bonds with call/put options etc. shall not be permitted as reference and deliverable obligations.

6. Market-makers and users in OTC market

6.1 Market-makers

(i) The following entities shall be eligible to act as market-makers in credit derivatives:

a. Scheduled Commercial Banks (SCBs), except Small Finance Banks, Payment Banks, Local Area Banks and Regional Rural Banks;

b. Non-Bank Financial Companies (NBFCs), including Housing Finance Companies (HFCs), with a minimum net owned funds of ₹500 crore as per the latest audited balance sheet and subject to specific approval of the Department of Regulation (DoR), Reserve Bank.

c. Standalone Primary Dealers (SPDs) with a minimum net owned funds of ₹500 crore as per the latest audited balance sheet and subject to specific approval of the Department of Regulation (DoR), Reserve Bank.

d. Exim Bank, National Bank of Agriculture and Rural Development (NABARD), National Housing Bank (NHB) and Small Industries Development Bank of India (SIDBI).

(ii) In case the net owned funds of an NBFC, an HFC or an SPD as per the latest audited balance sheet fall below the aforesaid threshold subsequent to the receipt of approval for acting as a market-maker, it shall cease to act as a market-maker. The NBFC, HFC or SPD shall continue to meet all its obligations under existing contracts till the maturity of such contracts.

(iii) Market-makers shall be allowed to buy protection without having the underlying debt instrument.

(iv) At least one of the parties to a CDS transaction shall be a market-maker or a central counter party authorised by the Reserve Bank as an approved counterparty for CDS transactions.

6.2 User Classification Framework

(i) For the purpose of offering credit derivative contracts to a user, market-maker shall classify the user either as a retail user or as a non-retail user.

(ii) The following users shall be eligible to be classified as non-retail users:

a. Insurance Companies regulated by Insurance Regulatory and Development Authority of India (IRDAI);
b. Pension Funds regulated by Pension Fund Regulatory and Development Authority (PFRDA);
c. Mutual Funds regulated by Securities and Exchange Board of India (SEBI);
d. Alternate Investment Funds regulated by Securities and Exchange Board of India (SEBI);
e. SPDs with a minimum net owned funds of ₹500 crore as per the latest audited balance sheet;
f. NBFCs, including HFCs, with a minimum net owned funds of ₹500 crore as per the latest audited balance sheet;
g. Resident companies with a minimum net worth of ₹500 crore as per the latest audited balance sheet; and
h. Foreign Portfolio Investors (FPIs) registered with SEBI.

(iii) Any user who is not eligible to be classified as a non-retail user shall be classified as a retail user.

(iv) Any user who is otherwise eligible to be classified as a non-retail user shall have the option to get classified as a retail user.

(v) Retail users shall be allowed to undertake transactions in permitted credit derivatives for hedging their underlying credit risk.

(vi) Non-retail users shall be allowed to undertake transactions in credit derivatives for both hedging and other purposes.

6.3 Protection sellers in CDS

(i) In addition to market-makers, the following non-retail users shall be eligible to act as protection sellers in CDS:

a. Insurance Companies regulated by IRDAI;
b. Pension Funds regulated by PFRDA;
c. Mutual Funds regulated by SEBI;
d. Alternate Investment Funds regulated by SEBI; and
e. Foreign Portfolio Investors (FPIs) registered with SEBI.

(ii) Protection selling by FPIs shall be subject to the provisions of A.P. (DIR Series) Circular No. _ dated xxxx xx, 2021 (*to be issued*).

7. Operational Directions for CDS in OTC market

7.1 Buying, Unwinding and Settlement

(i) Market-makers and users shall not enter into CDS transactions if the counterparty is a related party or where the reference entity is a related party to either of the contracting parties.

(ii) Market-makers and users shall not buy/sell protection on reference entities if there are regulatory restrictions on assuming similar exposures in the cash market or in violation of any other regulatory restriction, as may be applicable.

(iii) Market-makers shall ensure that all CDS transactions by retail users are undertaken for the purpose of hedging i.e. the retail users buying protection:

a. shall have exposure to any of the debt instruments mentioned under paragraph 5(ii) and issued by the reference entity;
b. shall not buy CDS for amounts higher than the face value of the underlying debt instrument held by them; and

c. shall not buy CDS with tenor later than the maturity of the underlying debt instrument held by them or the standard CDS maturity date immediately after the maturity of the underlying debt instrument.

To ensure this, market-makers may call for any relevant information/documents from the retail user, who, in turn, shall be obliged to provide such information.

(iv) Retail users shall exit their CDS position within one month from the date they cease to have underlying exposure.

(v) Market participants can exit their CDS contract by unwinding the contract with the original counterparty or assigning the contract to any other eligible market participant.

(vi) Market participants shall settle CDS contracts bilaterally or through any clearing arrangement approved by the Reserve Bank.

(vii) CDS contracts shall be denominated and settled in Indian Rupees.

(viii) CDS contracts can be cash settled or physically settled. However, CDS contracts involving retail users shall be mandatorily physically settled.

(ix) The reference price for cash settlement shall be determined in accordance with the procedure determined by the Credit Derivatives Determinations Committee or auction conducted by the Credit Derivatives Determinations Committee, as specified under paragraph 8 of these Directions.

7.2 Standardisation

(i) Fixed Income Money Market and Derivatives Association of India (FIMMDA), in consultation with market participants and based on international best practices, shall devise standard master agreement/s for the Indian CDS market which shall, *inter-alia*, include credit event definitions and settlement procedures.

(ii) FIMMDA shall, at the minimum, publish the following trading conventions for CDS contracts:

a. Standard maturity and premium payment dates;
b. Standard premiums;
c. Upfront fee calculation methodology;
d. Accrual payment for full first premium;
e. Quoting conventions; and

f. Lookback period for credit events.

7.3 Documentation

(i) Market participants shall use a standard master agreement for CDS contracts.

(ii) The CDS contracts shall, *inter-alia*, mention the following:

a. reference entity, reference obligation and/or deliverable obligation(s);

b. credit event definitions; and

c. the method and procedure of settlement.

(iii) The CDS contract shall represent a direct claim on the protection seller. The contract shall not have any clause that may:

a. allow the protection seller to unilaterally cancel the contract, except in case of a default by the protection buyer under the terms of the contract;

b. prevent the protection seller from making the credit event payment in a timely manner, after occurrence of the credit event and completion of necessary conditions and requirements under the terms of contract; or

c. provide the protection seller any recourse to the protection buyer for credit event losses.

7.4 Customer protection

(i) Market-makers in OTC markets shall comply with the Comprehensive Guidelines on Derivatives issued vide RBI Circular No. DBOD.No.BP.BC.86/21.04.157/2006-07 dated April 20, 2007, as amended from time to time and Reserve Bank of India (Prevention of Market Abuse) Directions, 2019.

7.5 Reporting

(i) Market-makers shall report all OTC CDS transactions within 30 minutes of the transaction, to the trade repository of Clearing Corporation of India Ltd. (CCIL). While reporting transactions between market-makers and users, it should be clearly indicated whether the transaction is for hedging or other purposes.

(ii) In case a market participant assigns a CDS contract to any other market participant, the market-maker in the assigned contract shall report such assignment to the trade repository of CCIL.

8. Credit Derivatives Determinations Committee

(i) FIMMDA shall set up a Credit Derivatives Determinations Committee, consisting of market participants in credit derivatives as voting members. At least 25% of the members of the Credit Derivatives Determinations Committee shall be drawn from the users. Representatives of central counterparties and legal/consultancy firms may also participate in the Credit Derivatives Determinations Committee as observers.

(ii) FIMMDA shall establish the rules for governing the activities of the Credit Derivatives Determinations Committee in line with international best practices.

(iii) The Credit Derivatives Determinations Committee, when approached by market participants, shall make factual determinations regarding key provisions of credit derivative contracts including, but not limited to, occurrence of a credit event.

(iv) The Credit Derivatives Determinations Committee shall, in consultation with market participants, develop a standard procedure for determining the reference price for cash settlement of CDS contracts.

(v) The Credit Derivatives Determinations Committee, when approached by market participants, may conduct an auction to determine the reference price for cash settlement of CDS contracts. In case an auction is conducted, the Credit Derivatives Determinations Committee shall put in place procedures/safeguards to ensure that the reference price determined in the auction is not manipulated.

(vi) The decisions of the Credit Derivatives Determinations Committee shall be binding on the market participants.

9. Directions for exchanges

(i) Exchanges may offer standardised single-name CDS contracts with guaranteed cash settlement.

(ii) Retail users, as specified under paragraph 6.2, shall undertake transactions in exchange-traded CDS only for hedging their underlying credit risk.

(iii) The reference entities and reference obligations for exchange-traded CDS shall be as specified under paragraph 5 of these Directions.

(iv) The occurrence of a credit event in exchange-traded CDS and the procedure for determining the reference price for cash settlement shall be determined by the Credit

Derivatives Determinations Committee, as specified under paragraph 8 of these Directions.

(v) Exchanges shall obtain prior approval of the Reserve Bank before finalising or modifying the product design, eligible participants and other details of CDS contracts.

(vi) Exchanges shall ensure that users participating on exchanges are made adequately aware of the risks associated with CDS.

(vii) Foreign Portfolio Investors (FPIs) may transact in exchange-traded CDS as protection sellers and/or protection buyers subject to the provisions of A.P. (DIR Series) Circular No. _ dated xxxx xx, 2021 (*to be issued*).

(viii) Exchanges shall report all CDS transactions to the trade repository authorised for the purpose by the Reserve Bank, in the form and manner prescribed by the Reserve Bank.

(ix) Exchanges shall furnish any information relating to CDS transactions to the Reserve Bank or any other agency as may be specified by the Reserve Bank in the manner and format and within the time frame as may be specified by the Reserve Bank.

10. Valuation methodology

(i) Market-makers shall put in place appropriate and robust methodologies for marking to market the credit derivative contracts.

(ii) Market-makers shall use daily CDS curve published by FIMMDA or a benchmark administrator approved for the purpose by the Reserve Bank, or a proprietary model, to value their CDS positions.

(iii) Market-makers using their proprietary model for pricing shall disclose in their financial statements/notes to accounts, the price as per the proprietary model and the price as per the CDS curve published by FIMMDA or a benchmark administrator approved for the purpose. The disclosure shall include the rationale for using a particular model over another as well as an explanation for changes in the valuation methodology, where applicable.

11. Prudential norms, accounting and capital requirements

Market participants shall follow the applicable prudential norms and capital adequacy requirements for credit derivatives issued by their respective regulators. Credit derivative transactions shall be accounted for as per the applicable accounting standards prescribed by The Institute of Chartered Accountants of India (ICAI) or other standard setting organisations or as specified by the respective regulators of participants.

12. Obligation to provide information sought by the Reserve Bank

Participants in the credit derivatives market shall furnish any information relating to credit derivatives transactions to the Reserve Bank or any other agency as may be specified by the Reserve Bank in the manner and format and within the time frame as may be specified by the Reserve Bank.

13. Dissemination of data

Reserve Bank of India, or any other agency authorised by the Reserve Bank, may in public interest, publish information related to transactions in credit derivatives market.

14. These Directions shall apply to all credit derivative transactions entered into from the date the Directions come into effect. Existing Directions will continue to be applicable to credit derivatives transactions undertaken in accordance with the said Directions till the expiry of those contracts.

(Dimple Bhandia)
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