Guidelines for Credit Default Swaps - NBFCs as users

Definitions

The following definitions are used in these guidelines:

(i) **Credit event payment** – the amount which is payable by the credit protection seller to the credit protection buyer under the terms of the credit derivative contract following the occurrence of a credit event. The payment can be only in the form of **physical settlement** (payment of par in exchange for physical delivery of a deliverable obligation).

(ii) **Underlying asset / obligation** – The asset[1] which a protection buyer is seeking to hedge.

(iii) **Deliverable asset / obligation** – any obligation[2] of the reference entity which can be delivered, under the terms of the contract, if a credit event occurs. (Assets under (iii) above, will rank at least *pari-passu* or junior to the underlying obligation).

(iv) **Reference obligation** - the obligation[3] used to calculate the amount payable when a credit event occurs under the terms of a credit derivative contract. [A reference obligation is relevant for obligations that are to be cash settled (on a par-less-recovery basis).]

2. Operational requirements for CDS

a) A CDS contract should represent a direct claim on the protection seller and should be explicitly referenced to specific exposure, so that the extent of the cover is clearly defined and incontrovertible.

b) Other than non-payment by a protection buyer of premium in respect of the credit protection contract, it should be irrevocable.

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[1] Please refer to paragraph 2.4 of the circular IDMD.PCD.No. 5053 /14.03.04/2010-11 dated May 23, 2011.

[2] For the present, only deliverable obligation permitted in terms of guidelines on CDS vide circular IDMD.PCD.No. 5053 /14.03.04/2010-11 dated May 23, 2011.

[3] Please refer to paragraph 2.4 of the circular IDMD.PCD.No. 5053 /14.03.04/2010-11 dated May 23, 2011.

c) There should be no clause in the contract that would allow the protection seller unilaterally to cancel the credit cover or that would increase the effective cost of cover as a result of deteriorating credit quality in the hedged exposure.

d) The CDS contract should be unconditional; there should be no clause in the protection contract outside the direct control of the NBFC that could prevent the protection seller from being obliged to pay out in a timely manner in the event that the original counterparty fails to make the payment(s) due.

e) The credit events specified by the contracting parties should at a minimum cover:

(i) failure to pay the amounts due under terms of the underlying obligation that are in effect at the time of such failure (with a grace period that is closely in line with the grace period in the underlying obligation);

(ii) bankruptcy, insolvency or inability of the obligor to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due, and analogous events; and

(iii) restructuring of the underlying obligation (as contemplated in the guidelines on CDS issued vide Circular No. IDMD.PCD.No.5053/14.03.04/2010-11 dated May 23, 2011) involving forgiveness or postponement of principal, interest or fees that results in a credit loss event;

(iv) when the restructuring of the underlying obligation is not covered by the CDS, but the other requirements in paragraph 2 are met, partial recognition of the CDS will be allowed. If the amount of the CDS is less than or equal to the amount of the underlying obligation, 60% of the amount of the hedge can be recognised as covered. If the amount of the CDS is larger than that of the underlying obligation, then the amount of eligible hedge is capped at 60% of the amount of the underlying obligation.

f) If the CDS specifies deliverable obligations that are different from the underlying obligation, the resultant asset mismatch will be governed under paragraph (j).

g) The CDS shall not terminate prior to expiration of any grace period required for a default on the underlying obligation to occur as a result of a failure to pay[4].

h) 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 should provide that any required consent to such transfer may not be unreasonably withheld.

i) The identity of the parties responsible for determining whether a credit event has occurred should be clearly defined. This determination should not be the sole responsibility of the protection seller. The protection buyer should have the right/ability to inform the protection seller of the occurrence of a credit event.

j) A mismatch between the underlying obligation and the reference obligation or deliverable obligation is permissible if (1) the reference obligation or deliverable obligation ranks *pari passu* with or is junior to the underlying obligation, and (2) the underlying obligation and reference obligation or deliverable obligation share the same obligor (i.e. the same legal entity) and legally enforceable cross-default or cross-acceleration clauses are in place.

(k) A mismatch between the underlying obligation and the obligation used for purposes of determining whether a credit event has occurred is permissible if (1) the latter obligation ranks *pari passu* with or is junior to the underlying obligation, and (2) the underlying obligation and reference obligation share the same obligor (i.e. the same legal entity) and legally enforceable cross-default or cross acceleration clauses are in place.

3. Treatment of exposures below materiality thresholds

Materiality thresholds on payments below which no payment is made in the event of loss as per the CDS contract, are equivalent to retained first loss positions and should be assigned risk weight of 667% (1/0.15*100 as minimum CRAR requirement for NBFCs is 15%) for capital adequacy purpose by the protection buyer.

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[4] Definition of maturity – the maturity of the underlying exposure and the maturity of the hedge should both be defined conservatively. The effective maturity of the underlying should be gauged as the longest possible remaining time before the counterparty is scheduled to fulfill its obligation, taking into account any applicable grace period.

4. Prudential treatment post-credit event

In case the credit event payment is not received within the period as stipulated in the CDS contract, the NBFC shall ignore the credit protection of the CDS and reckon the credit exposure on the underlying asset and maintain appropriate level of capital and provisions as warranted for the exposure. On receipt of the credit event payment, (a) the underlying asset shall be removed from the books if it has been delivered to the protection seller; or (b) the book value of the underlying asset shall be reduced to the extent of credit event payment received if the credit event payment does not fully cover the book value of the underlying asset and appropriate provisions shall be maintained for the reduced value.

5. Capital Adequacy

In terms of NBFC Prudential Norms Directions, 2007, risk weights for credit risk for corporate bonds held by NBFCs is 100%. A CDS contract creates a counterparty exposure on the protection seller on account of the credit event payment. In case of hedging of the cash position by CDS, the exposure will be reckoned on the protection seller subject to the conditions mentioned in para 6 below. NBFCs shall calculate the counterparty credit risk charge for all bought CDS positions as the sum of the current mark-to-market value, (if positive and zero, if MTM is negative) and the potential future exposure.

6. Treatment of exposure to the protection seller

6.1 Exposure to the underlying asset in respect of the hedged exposure shall be deemed to have been substituted by exposure to the protection seller, if the following conditions are satisfied:

a. Operational requirements mentioned in para 2 are satisfied

b. There is no maturity mis-match between the underlying asset and the deliverable obligation. If this condition is not satisfied, then the amount of credit protection to be recognised should be computed as indicated in paragraph 6.2 below.

In all other cases the exposure will be deemed to be on the underlying asset.

6.2 Risk weights as applicable to the underlying assets shall be applied for the unprotected portion of the exposure. The amount of credit protection shall be adjusted if there are any mismatches between the underlying asset/ obligation and the deliverable asset / obligation with regard to *asset* or *maturity*. These are dealt with in detail in the following paragraphs.

6.3 Mismatches

The amount of credit protection shall be adjusted if there are any mismatches between the underlying asset/ obligation and the deliverable asset / obligation with regard to *asset* or *maturity*.

(i) Asset mismatches

Asset mismatch will arise if the underlying asset is different from the deliverable obligation. Protection will be reckoned as available to the NBFC only if the mismatched assets meet the requirements specified in paragraph 2 (j) above.

(ii) Maturity mismatches

The NBFC would be eligible to reckon the amount of protection if the maturity of the credit derivative contract were to be equal to the maturity of the underlying asset. If, however, the maturity of the CDS contract is less than the maturity of the underlying asset, then it would be construed as a maturity mismatch. In case of maturity mismatch the amount of protection will be determined in the following manner:

a. If the residual maturity of the credit derivative product is less than **three months** no protection will be recognized.

b. If the residual maturity of the credit derivative contract is **three months** or more protection proportional to the period for which it is available will be recognised. When there is a maturity mismatch the following adjustment will be applied.

$$\mathbf{Pa = P \times (t - .25) \div (T - .25)}$$

Where:

Pa = value of the credit protection adjusted for maturity mismatch
P = credit protection
t = min (T, residual maturity of the credit protection arrangement) expressed in years
T = min (5, residual maturity of the underlying exposure) expressed in years

Example: *Suppose the underlying asset is a corporate bond of Face Value of Rs. 100 where the residual maturity is of 5 years and the residual maturity of the CDS is 4 years. The amount of credit protection is computed as under:*

$$100 * \{(4-.25) \div (5-.25)\} = 100*(3.75\div 4.75) = 78.95$$

c. Once the residual maturity of the CDS contract reaches **three months**, protection ceases to be recognised.

6.4 NBFCs as users need to adhere to all the criteria required for transferring the exposures fully to the protection seller in terms of paragraph 7.1 above on an on-going basis so as to qualify for exposure relief on the underlying asset. In case any of these criteria are not met subsequently, the NBFC will have to reckon the exposure on the underlying asset. Therefore, NBFCs should restrict the total exposure to an obligor including that covered by way of CDS within an internal exposure ceiling considered appropriate by the Board of the NBFC in such a way that it does not breach the single / group borrower exposure limit prescribed by RBI. In case of the event of any breach in the single / group borrower exposure limit, the entire exposure in excess of the limit will be risk weighted at 667%. In order to ensure that consequent upon such a treatment, the NBFC does not breach the minimum capital requirement prescribed by RBI, it should keep sufficient cushion in capital in case it assumes exposures in excess of normal exposure limit.

6.5 No netting of positive and negative marked-to-market values of the contracts with the same counterparty will be allowed for the purpose of complying with the exposure norms.

7. General Provisions Requirements

For the CDS positions of NBFCs, they should hold general provisions for gross positive marked-to-market values of the CDS contracts.

8. Reporting Requirement:

On a quarterly basis, NBFCs should report "total exposure" in all cases where they have assumed exposures against borrowers in excess of the normal single / group exposure limits due to the credit protections obtained by them through CDS, guarantees or any other permitted instruments of credit risk transfer, to the Regional Office of Department of Non-Banking Supervision where they are registered.

9. NBFCs shall also disclose in their notes to accounts of balance sheet the details given in annex- 2.

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Annex-2

Format of disclosure to be made in the Annual Financial Statements

(Rs. crore)

1. No. of transactions during the year

2. Amount of protection bought during the year

3. No. of transactions where credit event payment was received during the year

   a) pertaining to current year's transactions
   b) pertaining to previous year(s)' transactions

4. Outstanding transactions as on March 31:

   a) No. of Transactions
   b) Amount of protection

5. Net income/ profit (expenditure/ loss) in respect of CDS transactions during year-to-date:

   a) premium paid
   b) Credit event payments received (net of value of deliverable obligation).