Master Direction DNBR.PD.004/03.10.119/2016-17 dated August 23, 2016 - <u>Master Direction - Standalone Primary Dealers (Reserve Bank) Directions, 2016</u> :

Sr. No.	Reference Paragraph	Existing Extract	Amended text in RBI regulation (track change mode)
1	Annex II – Para 2	The credit risk exposure attached to off-Balance Sheet items has to be first calculated by multiplying the face value of each of the off-Balance Sheet items by 'credit conversion factor (CCF)' as indicated below. This will then have to be again multiplied by the weights attributable to the relevant counter-party as specified under on-balance sheet items. …….	<u>2.1</u> The credit risk exposure attached to off-Balance Sheet items has to be first calculated by multiplying the face value of each of the off-Balance Sheet items by 'credit conversion factor (CCF)' as indicated below. This will then have to be again multiplied by the weights attributable to the relevant counter-party as specified under on-balance sheet items. ……. <u>2.2 Definitions and general terminology</u> <u>2.2.1 **Counterparty Credit Risk (CCR)** is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows. An economic loss would occur if the transactions or portfolio of transactions with the counterparty has a positive economic value at the time of default. CCR creates a bilateral risk of loss: the market value of the transaction can be positive or negative to either counterparty to the transaction. The market value is uncertain and can vary over time with the movement of underlying market factors.</u> <u>2.2.2 **Securities Financing Transactions (SFTs)** are</u>

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			transactions such as repurchase agreements, reverse repurchase agreements, security lending and borrowing and, collateralised borrowing and lending (CBLO), where the value of the transactions depends on market valuations and the transactions are often subject to margin agreements. 2.2.3 **Current Exposure** is the larger of zero, or the market value of a transaction or portfolio of transactions within a netting set with a counterparty that would be lost upon the default of the counterparty, assuming no recovery on the value of those transactions in bankruptcy. Current exposure is often also called Replacement Cost (RC). 2.2.4 **Netting Set** is a group of transactions with a single counterparty that are subject to a legally enforceable bilateral netting arrangement and for which netting is recognised for regulatory capital purposes. Each transaction that is not subject to a legally enforceable bilateral netting arrangement that is recognised for regulatory capital purposes should be interpreted as its own netting set for the purpose of these rules. Cross-Product Netting, i.e. inclusion of transactions of different product categories (OTC derivative transactions and repo /reverse repo) within the same netting set, is not

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			permitted.
2	Annex II – Para 3.2	**Current Exposure Method** (i) The credit equivalent amount of interest rate derivative contracts calculated using the current exposure method is the sum of current credit exposure and potential future credit exposure of these contracts. (ii) Current credit exposure is defined as the sum of the positive mark-to-market value of these contracts. The Current Exposure Method requires periodical calculation of the current credit exposure by marking these contracts to market, thus capturing the current credit exposure. (iii) Potential future credit exposure is determined by multiplying the notional principal amount of each of these contracts, irrespective of whether the contract has a zero, positive or negative mark-to-market value, by the relevant add-on factor indicated below according to the nature and residual maturity of the instrument.	**Current Exposure Method (used for measuring capital charge for default risk)** (i) The credit equivalent amount of interest rate derivative contracts calculated using the current exposure method is the sum of current ~~credit~~ exposure and potential future ~~credit~~ exposure of these contracts. (ii) While computing the credit exposure PDs may exclude 'sold options', provided the entire premium / fee or any other form of income is received / realised. (iii) Current ~~credit~~ exposure is defined as the sum of the positive mark-to-market value of these contracts. The Current Exposure Method requires periodical calculation of the current ~~credit~~ exposure by marking these contracts to market, thus capturing the current ~~credit~~ exposure. (iv) Potential future ~~credit~~ exposure is determined by multiplying the notional principal amount of each of these contracts, irrespective of whether the contract has a zero, positive or negative mark-to-market value, by the relevant add-on factor indicated below according to the nature and

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		Table 1: Credit Conversion Factor (CCF) for Interest Rate Derivative Contracts	residual maturity of the instrument. **Table 1: Credit Conversion Factor (CCF) for Interest Rate Derivative Contracts**

Existing Extract Table

Residual Maturity	CCF (%) Interest Rate Derivative Contracts
One year or less	0.50
Over one year to five years	1.00
Over five years	3.00

(iv) For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be set equal to the time until the next reset date. However, in the case of interest rate contracts which have residual maturities of more than one year and meet the above criteria, the CCF or add-on factor is subject to a floor of 1.0 per cent.

(v) No potential future credit exposure would be calculated for single currency floating / floating interest rate swaps; the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

Amended text in RBI regulation Table

Residual Maturity	CCF (%) Interest Rate Derivative Contracts
One year or less	0.50
Over one year to five years	1.00
Over five years	3.00

(v) For contracts with multiple exchanges of principal, the add-on factors are to be multiplied by the number of remaining payments in the contract.

(ivi) For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be set equal to the time until the next reset date. However, in the case of interest rate contracts which have residual maturities of more than one year and meet the above criteria, the CCF or add-on factor is subject to a floor of 1.0 per cent.

(vii) No potential future credit exposure would be calculated for single currency floating / floating interest rate swaps; the

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		(vi) Potential future exposures should be based on 'effective' rather than 'apparent notional amounts'. In the event that the 'stated notional amount' is leveraged or enhanced by the structure of the transaction, PDs must use the 'effective notional amount' when determining potential future exposure. For example, a stated notional amount of ₹ 5 crore with payments based on an internal rate of two times the applicable rate would have an effective notional amount of ₹ 10 crore. (vii) Bilateral netting of mark-to-market (MTM) values arising on account of such derivative contracts is not permitted. Accordingly, PDs should count their gross positive MTM value of such contracts for the purpose of capital adequacy.	credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value. (vi~~i~~) Potential future exposures should be based on 'effective' rather than 'apparent notional amounts'. In the event that the 'stated notional amount' is leveraged or enhanced by the structure of the transaction, PDs must use the 'effective notional amount' when determining potential future exposure. For example, a stated notional amount of ₹ 5 crore with payments based on an internal rate of two times the applicable rate would have an effective notional amount of ₹ 10 crore. ~~(vii) Bilateral netting of mark-to-market (MTM) values arising on account of such derivative contracts is not permitted. Accordingly, PDs should count their gross positive MTM value of such contracts for the purpose of capital adequacy.~~ (ix) When effective bilateral netting contracts as specified in para 5.5(B) of Annex II are in place, RC will be the net replacement cost and the add-on will be A_{Net} as calculated below: (a) Credit exposure on bilaterally netted forward transactions will be calculated as the sum of the net mark-

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			to-market replacement cost, if positive, plus an add-on based on the notional underlying principal. The add-on for netted transactions (A_{Net}) will equal the weighted average of the gross add-on (A_{Gross}) and the gross add-on adjusted by the ratio of net current replacement cost to gross current replacement cost (NGR). This is expressed through the following formula: $$A_{Net} = 0.4 \cdot A_{Gross} + 0.6 \cdot NGR \cdot A_{Gross}$$ where: NGR = level of net replacement cost / level of gross replacement cost for transactions subject to legally enforceable netting agreements*. A_{Gross} = sum of individual add-on amounts (calculated by multiplying the notional principal amount by the appropriate add-on factors set out in Table 1 under para 3.2 & Table under para 6 of Annex II and Table 3 under para 5.4.2 & Table 4 under para 5.5.2 of the Annex to circular no. IDMD.PCD.No. 2301/14.03.04/2011-12 dated November 30, 2011 on Guidelines on Capital Adequacy and

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			Exposure Norms for Credit Default Swaps (CDS), as amended from time to time) of all transactions subject to legally enforceable netting agreements with one counterparty.
			(b) For the purposes of calculating potential future exposure to a netting counterparty for forward foreign exchange contracts and other similar contracts in which the notional principal amount is equivalent to cash flows, the notional principal is defined as the net receipts falling due on each value date in each currency. The reason for this is that offsetting contracts in the same currency maturing on the same date will have lower potential future exposure as well as lower current exposure.
			Note: PDs must calculate NGR on a counterparty by counterparty basis for all transactions that are subject to legally enforceable netting agreements.
32	Annex II – Para 4	No reference	**4.3 Calculation of capital requirement** 4.3.1 The exposure amount after risk mitigation is calculated as follows: $E^* = \max \{0, [E \times (1 + H_e) - C \times (1 - H_c - H_{fx})]\}$ where:

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			E* = the exposure value after risk mitigation
			E = current value of the exposure for which the collateral qualifies as a risk mitigant
			H_e = haircut appropriate to the exposure
			C = the current value of the collateral received
			H_c = haircut appropriate to the collateral
			H_{fx} = haircut appropriate for currency mismatch between the collateral and exposure
			The exposure amount after risk mitigation (i.e., E*) will be multiplied by the risk weight of the counterparty to obtain the risk-weighted asset amount for the collateralised transaction. 4.3.2 The formula in paragraph 4.3.1 will be adapted as follows to calculate the capital requirements for transactions with bilateral netting agreements. The bilateral netting agreements must meet the requirements set out in para 5.5(A) of Annex II.
			E* = max {0, [(Σ(E) – Σ(C)) + Σ (Es x Hs) +Σ (Efx x Hfx)]}
			where:
			E* = the exposure value after risk mitigation
			E = current value of the exposure

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			C = the value of the collateral received
			Es = absolute value of the net position in a given security
			Hs = haircut appropriate to Es
			Efx = absolute value of the net position in a currency different from the settlement currency
			Hfx = haircut appropriate for currency mismatch
			The intention here is to obtain a net exposure amount after netting of the exposures and collateral and have an add-on amount reflecting possible price changes for the securities involved in the transactions and for foreign exchange risk if any. The net long or short position of each security included in the netting agreement will be multiplied by the appropriate haircut. All other rules regarding the calculation of haircuts stated in paragraphs 4.2 and 4.3.1 equivalently apply for PDs using bilateral netting agreements for repo-style transactions.
4	Annex II – Para 5	**5 Capital requirements for exposures to Central Counterparties (CCPs)** **5.1 Definitions** …..	**5 Capital requirements for exposures to Central Counterparties (CCPs)** **5.1 Definitions** …..**5.1.1 Counterparty Credit Risk (CCR)** is the risk that the counterparty to a transaction could default before the final

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		5.2 Scope of Application …	settlement of the transaction's cash flows. An economic loss would occur if the transactions or portfolio of transactions with the counterparty has a positive economic value at the time of default. CCR creates a bilateral risk of loss: the market value of the transaction can be positive or negative to either counterparty to the transaction. The market value is uncertain and can vary over time with the movement of underlying market factors. **5.1.2 Securities Financing Transactions (SFTs)** are transactions such as repurchase agreements, reverse repurchase agreements, security lending and borrowing and, collateralised borrowing and lending (CBLO), where the value of the transactions depends on market valuations and the transactions are often subject to margin agreements. **5.1.3 Hedging Set** is a group of risk positions from the transactions within a single netting set for which only their balance is relevant for determining the exposure amount or exposure at default under the CCR standardised method. **5.1.4 Current Exposure** is the larger of zero, or the market value of a transaction or portfolio of transactions within a netting set with a counterparty that would be lost upon the

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			~~default of the counterparty, assuming no recovery on the value of those transactions in bankruptcy. Current exposure is often also called Replacement Cost.~~

5.1.15 A **central counterparty (CCP)** is a clearing house that interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer and thereby ensuring the future performance of open contracts. A CCP becomes counterparty to trades with market participants through novation, an open offer system, or another legally binding arrangement. For the purposes of the capital framework, a CCP is a financial institution.

5.1.26 A **qualifying central counterparty (QCCP)** is an entity that is licensed to operate as a CCP (including a license granted by way of confirming an exemption), and is permitted by the appropriate regulator / overseer with respect to the products offered. This is subject to the provision that the CCP is based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established, and publicly indicated that it applies to the CCP on an ongoing basis, domestic rules and regulations that are consistent with |

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			the CPSS-IOSCO Principles for Financial Market Infrastructures.
			5.1.3~~7~~ A **clearing member** is a member of, or a direct participant in~~,~~ a CCP that is entitled to enter into a transaction with the CCP, regardless of whether it enters into trades with a CCP for its own hedging, investment or speculative purposes or whether it also enters into trades as a financial intermediary between the CCP and other market participants[8].
			5.1.4~~8~~ A **client** is a party to a transaction with a CCP through either a clearing member acting as a financial intermediary, or a clearing member guaranteeing the performance of the client to the CCP.
			5.1.5~~9~~ **Initial margin** means a clearing member's or client's funded collateral posted to the CCP to mitigate the potential future exposure of the CCP to the clearing member arising from the possible future change in the value of their transactions. For the purposes of these guidelines, initial margin does not include contributions to a CCP for mutualised loss sharing arrangements (i.e. in case a CCP uses initial margin to mutualise losses among the clearing

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			members, it will be treated as a default fund exposure).
			5.1.6~~10~~ Variation margin means a clearing member's or client's funded collateral posted on a daily or intraday basis to a CCP based upon price movements of their transactions.
			5.1.7~~11~~ Trade exposures include the current[9] and potential future exposure of a clearing member or a client to a CCP arising from OTC derivatives, exchange traded derivatives transactions or SFTs, as well as initial margin. It also include cash transactions routed through a CCP.
			5.1.8~~12~~ Default funds, also known as clearing deposits or guarantee fund contributions (or any other names), are clearing members' funded or unfunded contributions towards, or underwriting of, a CCP's mutualised loss sharing arrangements. The description given by a CCP to its mutualised loss sharing arrangements is not determinative of their status as a default fund; rather, the substance of such arrangements will govern their status.
			5.1.9~~13~~ Offsetting transaction means the transaction leg between the clearing member and the CCP when the clearing member acts on behalf of a client (e.g. when a clearing member clears or novates a client's trade).

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			Footnote 8: For the purposes of these guidelines, where a CCP has a link to a second CCP, that second CCP is to be treated as a clearing member of the first CCP. Whether the second CCP's collateral contribution to the first CCP is treated as initial margin or a default fund contribution will depend upon the legal arrangement between the CCPs. In such cases, if any, RBI should be consulted for determining the treatment of this initial margin and default fund contributions. *Footnote 9: For the purposes of this definition, the current exposure of a clearing member includes the variation margin due to the clearing member but not yet received.* **5.2 Scope of Application** …
5	Annex II – Para 6	... This will then have to be again multiplied by the weights attributable to the relevant counter-party as specified above. Foreign exchange contracts with an original maturity of 14 calendar days or less, irrespective of the	... This will then have to be again multiplied by the weights attributable to the relevant counter-party as specified above. Foreign exchange contracts with an original maturity of 14 calendar days or less, irrespective of the counterparty, shall

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		counterparty, shall be assigned "zero" risk weight as per international practice.	be assigned "zero" risk weight as per international practice. When effective bilateral netting contracts as specified in para 5.5 – Part B of Annex II are in place, the computation of credit exposure will be as detailed in para 3.2(ix) of Annex II.
6	Annex II – Para 8	No reference	**8. Capital charge for Collateralised OTC derivatives transactions** The calculation of the counterparty credit risk charge for an individual contract will be as follows: counterparty charge = [max(0,(RC + add-on) – CA)] x r x 15% where: RC = the replacement cost, add-on = the amount for potential future exposure calculated according to paragraph 3.2 of Annex II, CA = the volatility adjusted collateral amount under the comprehensive approach prescribed in paragraphs 4.2-4.3 of Annex II or zero if no eligible collateral is applied to the transaction, and r = the risk weight of the counterparty. When effective bilateral netting contracts are in place, RC will be the net replacement cost and the add-on will be A_{Net} as

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			calculated according to paragraph 3.2 of Annex II. The haircut for currency risk (Hfx) should be applied when there is a mismatch between the collateral currency and the settlement currency. Even in the case where there are more than two currencies involved in the exposure, collateral and settlement currency, a single haircut assuming a 10-business day holding period scaled up as necessary depending on the frequency of mark-to-market will be applied.