Annex 4

Master Circular DBR.No.BP.BC.4./21.06.001/2015-16 dated July 1, 2015 on Prudential Guidelines on Capital Adequacy and Market Discipline-New Capital Adequacy Framework (NCAF)

Sr. No.	Reference Paragraph	Existing Extract	Amended text in RBI regulation (track change mode)
1	5.15.4	…. (viii) Since the legal position regarding bilateral netting of counterparty credit exposures in derivative contracts is not unambiguously clear, bilateral netting of mark-to-market (MTM) values arising on account of such derivative contracts cannot be permitted. Accordingly, banks should count their gross positive MTM value of such contracts for the purpose of capital adequacy.	…. ~~(viii) Since the legal position regarding bilateral netting of counterparty credit exposures in derivative contracts is not unambiguously clear, bilateral netting of mark-to-market (MTM) values arising on account of such derivative contracts cannot be permitted. Accordingly, banks should count their gross positive MTM value of such contracts for the purpose of capital adequacy.~~ (viii) When derivative exposure is covered by an effective bilateral netting contract as specified in 5.15.4 (ix), 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-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

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			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[23A] 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 9 of paragraph 5.15.4 and paragraph 8.6.3) of all transactions subject to legally enforceable netting agreements with one counterparty. (b) For the purposes of calculating potential future credit exposure to a netting counterparty for forward foreign exchange contracts and other similar contracts in which

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			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. *Footnote 23A: Banks must calculate NGR on a counterparty by counterparty basis for all transactions that are subject to legally enforceable netting agreements.* *(ix) For capital adequacy purposes:* (a) Banks may net transactions subject to novation under which any obligation between a bank and its counterparty to deliver a given currency on a given value date is automatically amalgamated with all other obligations for the same currency and value date, legally substituting one single amount for the previous gross obligations. (b) Banks may also net transactions subject to any legally valid form of bilateral netting not covered in (a), including

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			other forms of novation. (c) In both cases (a) and (b), a bank will need to satisfy that it has: (i) A netting contract or agreement with the counterparty which creates a single legal obligation, covering all included transactions, such that the bank would have either a claim to receive or obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions in the event a counterparty fails to perform due to any of the following: default, bankruptcy, liquidation or similar circumstances; (ii) Written and reasoned legal opinions that, in the event of a legal challenge, the relevant courts and administrative authorities would find the bank's exposure to be such a net amount under: • The law of the jurisdiction in which the counterparty is chartered and, if the foreign branch of a counterparty is involved, then also under the law of the jurisdiction in which the

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			branch is located; • The law that governs the individual transactions; and • The law that governs any contract or agreement necessary to effect the netting. (iii) Procedures in place to ensure that the legal characteristics of netting arrangements are kept under review in the light of possible changes in relevant law. (d) Contracts containing walkaway clauses will not be eligible for netting for the purpose of calculating capital requirements under these guidelines. A walkaway clause is a provision which permits a non-defaulting counterparty to make only limited payments or no payment at all, to the estate of a defaulter, even if the defaulter is a net creditor.
	7.3.8	The repo-style transactions also attract capital charge for Counterparty credit risk (CCR), in addition to the credit risk and market risk. The CCR is defined as the risk of default by the counterparty in a repo-style transaction, resulting in non-delivery of the security lent/pledged/sold or non-repayment	7.3.8.1 The repo-style transactions also attract capital charge for Counterparty credit risk (CCR), in addition to the credit risk and market risk. The CCR is defined as the risk of default by the counterparty in a repo-style transaction, resulting in non-delivery of the security lent/pledged/sold or non-repayment of

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		of the cash. ………	the cash. ……. 7.3.8.2 The formula in paragraph 7.3.6 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 7.3.8.3 of these guidelines. $E^* = \max \{0, [(\Sigma(E) - \Sigma(C)) + \Sigma (Es \times Hs) + \Sigma (Efx \times Hfx)]\}$ where: E* = the exposure value after risk mitigation E = current value of the exposure 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

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			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 7.3.6-7.3.7 equivalently apply for banks using bilateral netting agreements for repo-style transactions. 7.3.8.3 The effects of bilateral netting agreements covering repo-style transactions will be recognised on a counterparty-by-counterparty basis if the agreements are legally enforceable in each relevant jurisdiction upon the occurrence of an event of default and regardless of whether the counterparty is insolvent or bankrupt. In addition, netting agreements must: a) provide the non-defaulting party the right to terminate and close-out in a timely manner all transactions under the

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			agreement upon an event of default, including in the event of insolvency or bankruptcy of the counterparty; b) provide for the netting of gains and losses on transactions (including the value of any collateral) terminated and closed out under it so that a single net amount is owed by one party to the other; c) allow for the prompt liquidation or setoff of collateral upon the event of default; and d) be, together with the rights arising from the provisions required in (a) to (c) above, legally enforceable in each relevant jurisdiction upon the occurrence of an event of default and regardless of the counterparty's insolvency or bankruptcy. (e) Netting across positions in the banking and trading book will only be recognised when the netted transactions fulfil the following conditions: (i) All transactions are marked to market daily[1]; and (ii) The collateral instruments used in the transactions are recognised as eligible financial collateral in the banking book.

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	7.3.9	No reference	A new paragraph is added as given below: **Collateralised OTC derivatives transactions** The calculation of the counterparty credit risk charge for an individual contract will be as follows: counterparty charge = [(RC + add-on) – C_A] x r x 9% where: RC = the replacement cost, add-on = the amount for potential future exposure calculated according to paragraph 5.15.4, C_A = the volatility adjusted collateral amount under the comprehensive approach prescribed in paragraphs 7.3.6-7.3.7 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 calculated according to paragraph 5.15.4. The haircut for currency risk (Hfx) should be applied when there is a

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			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.
	8.8.1.2 (vii)	…… Derivatives dealers generally use dynamic credit adjustments that reflect changes in the creditworthiness of their counterparties to the OTC derivatives portfolios. Adjustments for default risk are of two general kinds. The first includes allowances for anticipated credit losses, and the second includes the cost of capital held to cover unanticipated credit losses. Unearned credit spread adjustments are made to reflect the risk that the dealer will not receive payments because of anticipated defaults by the counterparty. These adjustments generally take into account netting arrangements and collateral. Thus, adjustments that dealers actually make for credit risk tend to be lower than adjustments that would be made if netting arrangements and collateral were ignored. In India, banks	…… Derivatives dealers generally use dynamic credit adjustments that reflect changes in the creditworthiness of their counterparties to the OTC derivatives portfolios. Adjustments for default risk are of two general kinds. The first includes allowances for anticipated credit losses, and the second includes the cost of capital held to cover unanticipated credit losses. Unearned credit spread adjustments are made to reflect the risk that the dealer will not receive payments because of anticipated defaults by the counterparty. ~~These adjustments generally take into account netting arrangements and collateral. Thus, adjustments that dealers actually make for credit risk tend to be lower than adjustments that would be made if netting arrangements and collateral were ignored. In India, banks have not so far been permitted to have netting~~

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		have not so far been permitted to have netting agreements in respect of derivatives transactions. Therefore, in cases where banks do not have models to estimate adjustment for unearned credit spreads, they may make provisions for expected losses by using CCF equal to 20% of the CCF used for computing the potential future exposure for the purpose of capital adequacy. ………	~~agreements in respect of derivatives transactions. Therefore, in cases where banks do not have models to estimate adjustment for unearned credit spreads, they may make provisions for expected losses by using CCF equal to 20% of the CCF used for computing the potential future exposure for the purpose of capital adequacy.~~ ………