

Guidelines on Exchange Traded Interest Rate Derivatives

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June 3, 2003

To
All Primary Dealers

Dear Sir,

Guidelines on Exchange Traded Interest Rate Derivatives

It has been decided to introduce exchange traded Interest Rate Derivatives (IRDs) to enable better risk management in the Indian market. In the first phase, the Securities and Exchange Board of India (SEBI) has decided to introduce anonymous order driven system for trading in Interest Rate Derivatives (IRDs) on The Stock Exchange, Mumbai (BSE) and National Stock Exchange (NSE) .

2. With a view to enabling Primary Dealers (PDs) to manage their exposure to interest rate risks, it has been decided to allow the them to deal in IRDs in a phased manner. In the first phase, such entities can transact only in interest rate futures on notional bonds and T-Bills for the limited purpose of hedging the risk in their underlying investment portfolio. Allowing transactions in a wider range of products, as also market making will be considered in the next stage on the basis of the experience gained.

3. While derivatives present immense opportunity for mitigating the market risks inherent in the balance sheet, it can also expose one to substantial losses on account of inadequate understanding of the product, absence of proper monitoring, poor risk control measures, etc. PDs desirous of transacting in IRDs on the stock exchanges should take specific approval from their Board covering, *inter alia*, the products that they may transact, size/composition of the investment portfolio intended to be hedged, organizational set-up to monitor, rebalance, report, account and audit such transactions. Further, it is desirable that derivative desks are created within the treasury and the management level responsibility clearly assigned.

4. The following norms will be applicable for transacting IRDs on the Futures and Options (F & O) segment of the stock exchanges:

- i) *Stock exchange regulation:* PDs desirous of taking trading membership of the Stock Exchanges should satisfy the membership criteria and also comply with the regulatory norms laid down by SEBI and the respective stock exchanges (BSE/NSE). Those not seeking membership of SEs can transact IRDs through approved F & O members of the exchanges.
- ii) *Settlement:*
 - a) As trading members of the F&O segment, PDs should settle their derivative trades directly with the clearing corporation/clearing house.
 - b) PDs participating through approved F & O members shall settle proprietary trades as a participant clearing member or through approved professional / custodial clearing members.
 - c) Broker / trading members of stock exchanges cannot be used for settlement of IRD transactions.
- iii) *Eligible underlying:* For the present, only the interest rate risk inherent in the portfolio of government securities, unless categorized as Held to Maturity for accounting

purposes, can be hedged. For this purpose, the securities intended to be hedged must be identified and carved out for monitoring purposes.

- iv) *Hedge criteria:* Interest Rate Derivative transactions undertaken on the exchanges shall be deemed as hedge transactions, if and only if,
- a) The hedge is clearly identified with the underlying government securities in the investment portfolio.
 - b) The effectiveness of the hedge can be reliably measured
 - c) The hedge is assessed on an ongoing basis and is “highly effective” throughout the period.
- v) *Hedge Effectiveness :* The hedge will be deemed to be “highly effective” if at inception and throughout the life of the hedge, changes in the marked to market value of the hedged items with reference to the marked to market value at the time of the hedging are “almost fully offset” by the changes in the marked to market value of the hedging instrument and the actual results are within a range of 80% to 125%. If changes in the marked to market values are outside the 80% -125% range, then the hedge would not be deemed to be highly effective.
The hedged portion of the investment portfolio should be notionally marked to market, at least at monthly intervals, for evaluating the efficacy of the hedge transaction.
- vi) *Accounting:* The Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI) is in the process of developing a comprehensive Accounting Standard covering various types of financial instruments including accounting for trading and hedging. However, as the formulation of the Standard is likely to take some time, the Institute has brought out a Guidance Note on Accounting for Equity Index Futures as an interim measure. Till ICAI comes out with a comprehensive Accounting Standard, PDs may follow the above guidance note *mutatis mutandis* for accounting of interest rate futures also. However, since PDs are being permitted to hedge their underlying portfolio which is subject to periodical mark to market, the following norms will apply
- a) If the hedge is “highly effective”, the gain or loss on the hedging instruments and hedged portfolio may be set off and any net gain / loss treated as per the accounting practice adopted for the investment portfolio.
 - b) If the hedge is not found to be "highly effective" no set off will be allowed and the underlying securities will be marked to market as per the accounting practices adopted for the portfolio.
 - c) Trading position in futures is not allowed. However, a hedge may be temporarily rendered as not “highly effective”. Under such circumstances, the relevant futures position will be deemed as a trading position. All deemed trading positions should be marked to market as a portfolio on a daily basis and losses should be provided for and gains, if any, should be ignored for the purpose of Profit & Loss Account. PDs should strive to restore their hedge effectiveness at the earliest.
 - d) Any gains realized from closing out / settlement of futures contracts can not be taken to Profit & Loss account but carried forward as "Other Liability" and utilized for meeting depreciation provisions on the investment portfolio.

- vii) *Capital Adequacy* : The net notional principal amount in respect of futures position with same underlying and settlement dates should be multiplied by the conversion factor given below to arrive at the credit equivalent:

Original Maturity	Conversion Factor
Less than one year	0.5 per cent
One year and less than two years	1.0 per cent
For each additional year	1.0 per cent

The credit equivalent thus obtained shall be multiplied by the applicable risk weight of 100%.

- viii) *ALM classification*: Interest rate futures are treated as a combination of a long and short position in a notional government security. The maturity of a future will be the period until delivery or exercise of the contract, as also the life of the underlying instrument. For example, a short position in interest rate future for Rs. 50 crore [delivery date after 6 months, life of the notional underlying government security 3½ years] is to be reported as a risk sensitive asset under the 3 to 6 month bucket and a risk sensitive liability in four years i.e. under the 3 to 5 year bucket.
- ix) *Use of brokers*: The existing norm of 5% of total transactions during a year as the aggregate upper contract limit for each of the approved brokers should be observed by PDs who participate through approved F & O members of the exchanges.
- x) *Client Trades* :PDs who are trading members of the Stock Exchanges may have to put up margins on behalf of their non-institutional client trades. Such margins are required to be collected upfront from the respective clients. PDs are not permitted to pay up margins on behalf of their client trades and incur overnight credit exposure to their clients. In so far as the intra day exposures on clients for margins are concerned, the PDs should be conscious of the underlying risks in such exposures.
- xi) *Disclosures*: The PDs undertaking interest rate derivatives on exchanges may disclose as a part of the notes on accounts to balance sheets the following details:

(Rs. Crores)

Sr.No.	Particulars	Amount
1	Notional principal amount of exchange traded interest rate derivatives undertaken during the year (instrument-wise) a) b) c)	
2	Notional principal amount of exchange traded interest rate derivatives outstanding as on 31 st March ____ (instrument-wise) a) b) c)	
3	Notional principal amount of exchange traded interest rate derivatives outstanding and not “highly effective” (instrument-wise) a) b) c)	

4	Mark-to-market value of exchange traded interest rate derivatives outstanding and not “highly effective” (instrument-wise) a) b) c)	
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- xii) *Reporting:* Primary dealers should submit a monthly statement to IDM Cell as per the enclosed format.

5. The above guidelines are subject to review based on the feedback and experience.

6. These guidelines may be placed before the Board of Directors for formulating the policy, framework and appropriate risk control measures before the regulated entities undertake trades in interest rate futures on the stock exchanges.

7. Please acknowledge receipt.

Yours faithfully,

(Charan Singh)
Director

MONTHLY RETURN ON EXCHANGE TRADED INTEREST RATE FUTURES

Name of the PD:

As on last working day of the month:

I. Analysis of outstanding futures position :

Settlement dates of the Futures Contract outstanding in the books	Underlying interest rate exposure of the futures contract	Number of Contracts outstanding in the books	Open Interest position of the futures contract
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II. Activity during the month :

NPA* of the futures contract outstanding at the beginning of the month (settlement date / underlying interest rate exposure wise break up)	NPA * entered into during the month (settlement date / underlying interest rate exposure wise break up)	NPA* of the futures contract reversed during the month (settlement date / underlying interest rate exposure wise break up)	NPA* outstanding at the end of the month (settlement date / underlying interest rate exposure wise break up)
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II. Analysis of “highly effective” hedges:

Size of the underlying investment portfolio being	Change in MTM*** value of the underlying hedge portfolio	Change in MTM*** value of the futures position since	PV01** of the underlying investment portfolio being	PV01** of the hedging futures position
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hedged	since inception of hedge	inception of hedge	of hedged	
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III. Analysis of not “highly effective” hedges:

Size of the underlying investment portfolio intended to be hedged	Change in MTM*** value of the underlying hedge portfolio since inception of hedge	Change in MTM*** value of the futures position since inception of hedge	Duration for which the hedge was ineffective	Remark : Action if any, to restore hedge effectiveness
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* NPA- Notional principal amount

**PV01-Price value of a basis point

***MTM- Marked to market