Implementation Group on OTC Derivatives Market Reforms

Reserve Bank of India

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Executive Summary

The recent financial crisis exposed weaknesses in the structure of the over-the-counter (OTC) derivatives markets that had contributed to the build-up of systemic risk. In response to the financial crisis, the G-20 initiated a series of reforms designed to strengthen the regulation and oversight of the financial system and tasked the Financial Stability Board (FSB) with coordinating the reforms and assessing their implementation.

2. An important aspect of these reforms is a commitment to enhance the regulation of OTC derivatives markets so as to improve transparency, mitigate systemic risk and protect against market abuse. The reforms agenda consists of standardization, central clearing, exchange or electronic platform trading, margining and reporting of OTC derivatives transactions to trade repositories. India is committed to achieve the G-20 reform agenda for OTC derivatives.

3. In India, the small size of the OTC derivatives market, low level of complexity in products and robust regulation resulted in orderly derivatives market development and reduced the concerns with regard to systemic risk. The OTC derivative products were introduced in a phased manner keeping in view the hedging needs of the real sector. Reserve Bank has focused on improving transparency and reducing counterparty risk in the OTC derivatives markets and fostered development of robust market infrastructure for trading, settlement and reporting of transactions. As RBI has initiated steps for adoption of the G-20 / FSB reforms, reasonable progress has been made in implementing the OTC derivative reform measures in India.

4. While it is desirable to achieve consistency in implementation across jurisdictions and within jurisdictions along with promoting greater use of OTC derivatives products in standardized form and minimizing the potential for regulatory arbitrage, there exist several implementation issues which impact the pace and direction of the reform initiatives. Size and depth of the market, complexity of the products, characteristics of the market participants and their motivation to enter into derivatives trades etc. impact the reforms. While India is fully committed to reforms, the pace and nature of reforms, depends on the domestic market conditions.

5. Roadmap for implementation of reform measures with regard to OTC derivatives in India has been worked out with timelines extending up to March 2015 is recommended. As some of the milestones are dependent on exogenous variables like improvement in liquidity, there is a possibility that the timelines may be revisited / revised based on developments in the OTC derivatives market. However, to clearly articulate our commitment to G-20 reform agenda and spell out path for implementation, it is recommended that the Working Group report which contains roadmap / timelines may be placed in public domain. Regulatory reform of OTC derivatives is very important from financial stability perspective. Therefore, all the stakeholders need to strive for implementation of the reforms as per the recommended roadmap to ensure a vibrant OTC derivatives market.

Chapter I

Introduction

Financial derivatives markets improve the resilience of the financial system by allowing market participants to effectively manage risks. However, rapid growth in over-the-counter (OTC) derivatives markets over the past decade has been accompanied by an increasing awareness of the systemic importance of these markets, and potential risks inherent in market practices.

2. The financial crisis demonstrated that poor transparency, misaligned incentives and inadequate liquidity hinder financial markets. The financial crisis in 2008 exposed weaknesses in the structure of the over-the-counter (OTC) derivatives markets that had contributed to the build-up of systemic risk and potential for contagion arising from the interconnectedness of OTC derivatives market participants and the limited transparency of the markets.

3. In response to the financial crisis, the G-20 initiated a series of reforms designed to strengthen the regulation and oversight of the financial system and tasked the Financial Stability Board (FSB) with coordinating the reforms and assessing their implementation.

4. An important part of these reforms is a commitment to enhance the regulation of OTC derivatives markets so as to improve transparency, mitigate systemic risk and protect against market abuse. To further these ends, the G-20 decided at the September 2009 Pittsburgh leaders' Summit that:

"All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements."

In November 2011, the G-20 further directed that internationally consistent minimum standards be developed for the margining of non-centrally cleared OTC derivatives and called upon the Basel Committee on Banking Supervision (BCBS) and International

Organization of Securities Commissions (IOSCO) to develop for consultation, consistent global standards for these margin requirements.

5. These commitments for reforming OTC derivatives markets aimed at achieving the overarching goals of the G-20 to increase transparency, mitigate systemic risk and protect against market abuse. The reforms include:

• Reporting transaction details to trade data repositories (TRs) which improves transparency both for the official sector and for market participants. This supports the management of systemic risk by allowing the official sector to monitor and react to the aggregate build‐up of risk and permitting market participants to better understand and price risk.

• Standardization contributes to market transparency and liquidity. Sufficient standardization, both in terms of contractual details and operational processes, is necessary for OTC derivatives transactions to be centrally cleared and traded on exchanges or electronic trading platforms.

• In turn, clearing through Central Counterparties (CCPs) reduces systemic risk by improving counterparty risk management, reducing interconnectedness and enhancing the netting of financial exposures. This reduces the probability that the default of a market participant will destabilize other participants.

• Exchanges and electronic trading platforms also improve transparency and help to reduce market abuse by standardizing trading rules and processes and bringing them into the open.

- Higher capital and margin requirements reduce systemic risk by creating a buffer that can absorb losses and by creating incentives to properly manage risk. Incentives provided by capital and margin requirements for non‐standardised derivatives will motivate increased use of standardised products and discourage spurious customisation.

6. As G20 has tasked FSB to monitor the progress in OTC derivatives reforms, the FSB made 21 recommendations in the October 2010 report on *Implementing OTC Derivatives Market Reforms,* addressing practical issues that the authorities may

encounter in implementing these commitments concerning standardization, central clearing, exchange or electronic platform trading and reporting of OTC derivatives transactions to trade repositories which were endorsed by G-20 Leaders at the Seoul Summit in October 2010. The recommendations are given in Annex I.

7. The summary of recommendations is as under:

- *Standardization:* The proportion of the market that is standardized should be substantially increased in order to further G-20's goals of increased central clearing and trading on organized platforms, and hence mitigate systemic risk and improve market transparency.
- *Central clearing:* To implement the G-20 commitment effectively, it is necessary to specify the factors that should be taken into account when determining whether a derivative contract is standardized and therefore suitable for clearing. In addition to mandatory clearing requirements, robust risk management requirements for the remaining non-centrally cleared markets; and supervision, oversight and regulation of central counterparties (CCPs) themselves need to be prescribed.
- *Exchange or electronic platform trading:* Identify what actions may be needed to fully achieve the G20 commitment that all standardized products be traded on exchanges or electronic trading platforms, where appropriate.
- *Reporting to trade repositories:* Authorities must have a global view of the OTC derivatives markets, through full and timely access to the data needed to carry out their respective mandates. The trade repository data must be comprehensive, uniform and reliable and, if from more than one source, provided in a form that facilitates aggregation on a global scale.

8. In order to give effect to the G-20 commitments, global regulatory reform initiatives are underway e.g., the US Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), the Markets in Financial Instruments Directive/Regulation (MiFID II/ MiFIR) and the European Market Infrastructure Regulation (EMIR).

Progress in implementation of recommendations

9. FSB member jurisdictions are fully committed to completing the agreed reforms and are making some progress. The progress can be summarised as follows:

- The European Union, Japan and the United States – having the largest volumes of OTC derivatives activity – are among the most advanced in implementing legislative and regulatory reform, with several key regulatory measures in force (or becoming so) by mid-2013. Even so, the timeline for applying the full spectrum of reforms to implement the G-20 commitments still stretches well beyond 2013.
- Several jurisdictions are in the process of implementing regulatory measures related to trade reporting and these measures are expected to come into force over the course of this year. A few jurisdictions expect clearing requirements to come into force in 2013–2014.
- At present only three jurisdictions have (or expect to soon have) requirements adopted and in force for OTC derivatives to be traded on organised platforms. [Source: FSB: OTC Derivatives Market Reforms- Fifth Progress Report on Implementation - April 2013]

10. The Working Group on Margining Requirements (WGMR) formed in October 2011 to develop a proposal on margin requirements for non-centrally-cleared derivatives has recently finalised its recommendations on initial and variation margins. Further, the Basel III capital framework for banks included higher capital requirements for non-centrally cleared transactions, to incentivize move towards central clearing. Several jurisdictions including India are in the process of implementing the capital framework.

Constitution of Working Group

11. India is committed to achieve the G-20 reform agenda for OTC derivatives. In order to guide the process of implementation of the key reform measures being undertaken by FSB, an Implementation Group on OTC derivatives Market Reforms has been constituted on the directions of the Sub Committee of the Financial Stability and

Development Council with representatives from Reserve Bank of India (RBI) and market participants with Shri R. Gandhi, Executive Director, RBI as Chairman.

12. The mandate/terms of reference of the implementation group are:

- To undertake an assessment of the position of compliance of the regulatory framework in the country vis-à-vis the FSB policy guidelines in the reform area concerned;
- Carry out a gap analysis to identify the reform measures that can be implemented and those where implementation may not be desirable given the specific domestic conditions;
- Where it may not be desirable to implement the reform measures, the group will document the same setting out the reasons within an overall "comply or explain" framework;
- To set out a roadmap indicating the timelines for implementation of the reform area concerned together with the regulator/ agency which will implement the reforms and the framework for monitoring;
- To recommend whether publishing of a formal approach to implementation of reform measures, as being done by several jurisdictions for some of the reform areas, would be appropriate in the Indian context.

The members of the Group are listed in Annex II.

13. The Group held one meeting. The report is based on the deliberations of the Group. The report is arranged as under two sections: (i) An assessment of position of compliance of regulatory framework in India vis-à-vis FSB policy guidelines, and (ii) Future roadmap in context of reforms and conclusion.

Chapter II

Assessment of the position of compliance of the regulatory framework in the country vis-à-vis the FSB policy guidelines

The OTC derivatives permitted to be traded in India are interest rate swaps (IRS), forward rate agreements (FRA), forex forwards, currency options and swaps and credit default swaps (CDS).

2. The Reserve Bank of India Act, 1934 empowers RBI to regulate OTC products such as interest rate derivatives, foreign currency derivatives and credit derivatives. Therefore necessary legal and regulatory mechanism is in place in India to carry out the OTC derivatives reform.

Present Status in India

3. In India, the small size of the OTC derivatives market, low level of complexity in products and regulatory structure which mandates that validity of any OTC derivative contract is contingent on one of the parties to the transaction being a regulated entity, resulted in orderly derivatives market development and lessened the concerns with regard to systemic risk. The OTC derivative products were introduced in a phased manner keeping in view the hedging needs of the real sector. Reserve Bank has focused on improving transparency and reducing counterparty risk in the OTC derivatives markets and fostered development of robust market infrastructure for trading, settlement and reporting of transactions. As India is committed to implementation of the G-20 / FSB reforms, reasonable progress has been made in implementing the OTC derivative reform measures in India. The status of reforms is as under:

- *Standardization*: The process of standardization is planned to be undertaken gradually. Product wise status of standardisation is as follows: CDS transactions are standardized in terms of documentation, coupon, coupon payment date etc. Following the recommendations of the Working Group on Enhancing Liquidity in the Government Securities and Interest Rate Derivatives Markets [Chairman: Shri R. Gandhi][Gandhi Committee], it has been decided to standardise IRS contracts to facilitate centralized clearing and settlement of these contracts. IRS on Overnight Index Swap for interbank trades has been standardized from April 1, 2013. Other benchmarks in IRS would be standardized in a phased manner. Foreign exchange derivatives are generally 'plain vanilla' and majority of interbank trades are driven by customized client trades.

- *Central clearing*: Calibrated steps towards central clearing of OTC derivative transactions are being taken. More than 90% of IRS trades are currently being centrally cleared on a non-guaranteed basis without regulatory mandate. CCIL carries out regular portfolio compression exercise on IRS to reduce the overall systemic risk. Further, CCIL has also introduced a facility wherein trades matched between two interbank counterparties at CCIL may act as final confirmation and eliminate the paper confirmation, which eliminates operational risk. There is a guaranteed centralized clearing arrangement for settlement of USD-INR forwards though central clearing is not mandated by regulation. CDS market is still developing and it may take more time to achieve the necessary market activity to support central clearing of CDS transactions.

- *Exchange or electronic platform trading*: Electronic platforms are available for transactions involving forward rate agreements and foreign exchange swaps. Forex forwards can be traded on FX-SWAP trading platform. Gandhi Committee has also recommended introduction of an electronic swap execution facility (electronic trading platform) for the IRS market, and introduction of a CCP which may provide guaranteed settlement of trades executed through the electronic platform. The issue of modalities of introduction is under examination. Further market consultation is needed in order to finalize regulations for a mandatory trading requirement on electronic platforms.

- *Reporting to trade repositories*: RBI had already put in place a reporting arrangement for interbank/PD transactions in Rupee Interest Rate Swap

(IRS)/ Forward Rate Agreement (FRA) in August 2007 itself. The CCIL's reporting platform for OTC foreign exchange derivatives was introduced on July 9, 2012 and was expanded thereafter in three phases to cater to the reporting of interbank and client transactions (threshold of USD 1 million and equivalent in other currencies) in various actively used derivative instruments. The last phase was rolled out on December 30, 2013, in which reporting of client transactions in Rupee IRS/FRA was also covered. The reporting platform for Credit Default Swaps (CDS) was put in place from the date of introduction of the instrument itself, i.e., December 1, 2011. Thus, the current trade reporting arrangement covers Rupee IRS/FRA, Foreign Exchange Forwards, Foreign Exchange Options, FX Swaps, Currency Swaps, IRS/FRA in foreign currencies and CDS.

A table providing the current status is placed as appendix.

Future Road Map [with gap analysis]

4. While it is desirable to achieve consistency in implementation across jurisdictions and within jurisdictions, while promoting greater use of OTC derivatives products in standardized form and minimizing the potential for regulatory arbitrage, there exist several country specific implementation issues which impact the pace and direction of the reform initiatives. Size and depth of the market, complexity of the products, characteristics of the market participants and their motivation to enter into derivatives trades etc. impact the reforms. While India is fully committed to reforms, the pace and nature of reforms, depends on the domestic market conditions. A snapshot of market activity is given in Annex III. The future roadmap of reform- product wise is discussed below:

Trade Reporting/Trade Repository:

4.1 A trade repository is a centralised registry that maintains an electronic database of records of transactions. Use of trade repositories would improve operational efficiencies in post-trade processing, either by the trade repository or by other service providers that use the data maintained by the trade repository. Data from a trade repository can be used to facilitate electronic trade matching and confirmation, settlement of payment obligations, trade novation and affirmation, portfolio compression and reconciliation, and collateral management thereby resulting in risk reduction and improved operational efficiencies for individual market participants. Trade repositories can also serve an important role in enhancing the transparency of information to relevant authorities, market participants and the public. This full and timely information can be used to identify the build-up of systemic risks, help detect market abuse and facilitate greater market efficiency. Recognizing these benefits RBI has taken steps for improving the transparency of the OTC derivatives market. Regulatory reporting had been put in place in various forms according to the needs in case of OTC derivatives, particularly forex derivatives, much before the onset of the crisis. The Reserve Bank had even required mandated transaction level reporting much before the importance of transparency for financial safety was widely accepted. In pursuit of derivatives reform, significant progress has been achieved with regard to establishment of trade repositories and mandating disclosures.

4.1.1 *IRS:* Trade reporting platform is available for both interbank and client trades.
4.1.2 *Forex Forward, Forex Swaps & Options:* Reporting platform is available for both interbank and client trades. Trade reporting is mandatory.

4.1.3 *Currency Swaps, IRS in Foreign Currency, Interest Rate Options in Foreign Currency*: Reporting platform for interbank and client trades in currency swaps and IRS in foreign currency has been developed by CCIL and reporting has been made effective from December 30, 2013. As the trading volumes in FCY interest rate options are negligible, the instrument will be brought under the ambit of reporting later when the transaction volume picks up. It is recommended to take a review in this regard by March 2015.

4.1.4 *CDS:* Reporting platform is available for both interbank and client trades. Reporting of all trades is mandatory.

4.1.5 *Extraterritorial Legislation and Trade Repositories*: An important aspect that needs attention with regard to trade repositories is the impact of extraterritorial legislation. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) and European Market Infrastructure Regulation (EMIR) create a new regulatory regime for OTC derivative transactions mandating comprehensive reporting obligations for market participants wherein transaction and/or position data, including the identities of the counterparties ("Trade Data") of swap transactions must be reported to regulators or to data repositories, which collect and maintain Trade Data. These reporting requirements may potentially lead to conflicts of law in a number of other jurisdictions including India as privacy laws in non-U.S./non-Europe jurisdictions may prohibit the disclosure of Trade Data to SDRs. Financial Stability Board in its document on "implementing OTC derivatives market reforms" (October 2010) has stated that an analysis of G-20 jurisdictions has revealed that client confidentiality laws apply in a large number of jurisdictions.

4.1.6 In order to avoid breaching such laws, potential solutions have been identified, viz. obtaining client consent by having an industry standard protocol that fulfills the requirement for client consent and which effectively waives the right to confidentiality of the customers; changing the local law, such that, it has an overriding effect on the local client confidentiality laws. In this regard, dealing with several jurisdictions would present problems due to privacy legislation. Penalties for violating privacy laws can be severe—including damages, fines, loss of license to operate and even criminal sanctions. Resolution of the issue calls for global coordination. In this regard Commodity Futures Trading Commission (CFTC) and European Commission (EC) have reached an understanding on June 11, 2013 on the cross-border issues and agreed to take a common path forward in G-20 reform agenda, which is a welcome development. Reserve Bank is actively engaging with international regulators and agencies for satisfactory resolution of the issue.

4.2 *Standardisation:*

4.2.1 *IRS:* As mentioned elsewhere in this report, inter-bank IRS on Overnight Index Swap –MIBOR (Mumbai Inter-Bank Offer Rate) has been standardized since April 2013 by regulatory mandate. It was decided to follow a gradual approach and consider examining standardisation of other benchmarks [Mumbai Interbank Forward Offer Rate (MIFOR) and Indian Bench Mark (INBMK)] in a phased manner due to low liquidity. It is recommended that standardization in IRS may be made mandatory for all interbank trades in due course.

4.2.2 *Forex Forward and Forex Swaps*: As majority of interbank trades executed are to cover the non-standard client trades, it is recommended that standardization of forex forward/swap contracts may not be mandated for the present. The matter may be reviewed by March 2015.

4.2.3 *Forex Option:* Currently, option traded volumes are fairly low (about $ 100 million turnover in plain vanilla and about $200 million turnover in strategies per day). The instruments are not very standardized in terms of notional, tenors or terms of settlement. Interbank trades in Forex options are essentially entered to cover non-standard client trades, which are highly customized.. Hence it may be difficult for the market to standardize forex option trades and to comply with mandatory standardization of the same. As interbank trades in forex option are primarily to cover non-standard client trades, which are highly customized, it is recommended that standardization may not be made mandatory by the regulator for the present. However, it is recommended that the issue may be reviewed in March 2015.

4.2.4 *Currency Swaps, IRS in FCY, Interest Rate Option in FCY*: Market liquidity is very low to consider mandating standardisation of currency swaps, IRS in FCY and Interest rate options. It is recommended that the issue of standardisation may be re-examined by end-2015.

4.2.5 *CDS:* Contracts have been standardized by FIMMDA upon regulatory mandate by RBI.

4.3 ***CCP Clearing:***

4.3.1 A highly effective way to manage many of the counterparty and operational risks in financial markets, while also introducing standardisation and other efficiencies into the market, is for transactions to be centrally cleared. Through central clearing numerous bilateral exposures of a market participant can be substituted for a single net exposure to a CCP. The resulting multilateral netting has the potential to substantially reduce the size of individual counterparties' outstanding obligations relative to bilateral arrangements, while also reducing market-wide collateral needs. By acting as a central hub for market participants, CCPs can improve the effectiveness of default management arrangements, as well as coordinate operational improvements and efficiencies.

4.3.2 However, in order for a CCP to clear a certain class of products safely and reliably, a number of preconditions must be satisfied such as product that is under clearing must have a robust valuation methodology for that product so that the CCP can confidently determine margin and default fund requirements; must have sufficient liquidity in the market and there must be sufficient transaction activity and participation so that the fixed and variable costs of clearing the transaction are covered. These issues were considered while mandating CCP based clearing in India.

4.3.3 *IRS:* Non-guaranteed central clearing is being provided by CCIL. Though it is not mandatory for banks to clear interbank trades through CCIL's central clearing, more than 90% of trades are being centrally cleared. The proposal to provide CCP based clearing is already under consideration. It is recommended to make operational CCP based clearing by March 2014.

In the matter of mandating CCP based clearing for interbank trades, it is recommended that a decision may be taken by March 2015. One issue that merits examination in this context is exposure norms / limits for exposures to CCP which is being examined by RBI.

4.3.4 *Forex Forward and Forex Swaps:* Guaranteed central clearing facility is being provided by CCIL in forex forward. Though RBI has not mandated banks to clear their trades through the CCIL's CCP based clearing, currently around 30% of trades are being cleared under guaranteed settlement mechanism. As regards swaps, guaranteed central clearing facility is being provided by CCIL separately for the two legs of the swap. Keeping in view the benefits of CCP based clearing, it is recommended that CCP based clearing would be made mandatory for all interbank trades by March 2014.

4.3.5 *Forex Options*: There is no guaranteed central clearing facility for options due to limited market liquidity. It is recommended that the introduction of CCP clearing for forex options may be reviewed by March 2015 subject to improvement in liquidity.

4.3.6 *Currency Swaps, IRS in FCY, Interest Rate Option in FCY*: Market liquidity is not sufficient to consider CCP clearing. Hence, it is recommended that a review may be done by end-2015 to examine the possibility of introducing CCP based clearing.

4.3.7 *CDS:* Currently volumes in CDS are very low. As CCP based clearing which require reasonable volume to reliably calculate margin requirements has not been introduced. However, it is recommended that CCP based clearing for CDS contracts may be put in place by March 2015 subject to adequate liquidity in the instrument by that time.

4.3.8 *Extraterritorial Legislation and CCP Clearing***:** The US and European laws dealing with OTC derivatives reform have raised concerns over possibilities of extra territorial regulatory jurisdiction leading to regulatory conflict and disruptions for market activity. For instance, European Market Infrastructure Regulation (EMIR) and the Commodity Exchange Act (CEA) as modified by the Dodd-Frank Act contain prescriptive rules that may prevent European/US banks from participating in third-country clearing houses that have not applied for recognition by the European Securities and Markets Authority (ESMA) or that are not registered as a derivatives clearing organization (DCO) as per CFTC regulations. While the discussions are still on, the uncertainty over the inconsistencies between EU and US rules, the process and timeline for equivalence assessments may affect the trust in the functioning of international financial markets and may have impact on progress of implementation of G-20 reform agenda.

4.4 *Electronic trading platform:*

4.4.1 *IRS:* It was suggested to introduce an electronic trading platform for IRS and trades executed through the trading platform would be settled through CCP based clearing. Hence, development of the platform could be taken after introduction of CCP based clearing in IRS. It is estimated that CCIL would take 6-9 months' time from receipt of approval of RBI for developing platform for IRS. In view of this it is recommended that the electronic trading platform may to be put in place by September 2014 subject to approval from RBI.

4.4.2 *Forex Forward:* Currently, there is no exclusive trading platform available. However, forward trades can be traded in CCIL's FX-SWAP trading platform for certain maturities. Trading is not taking place as certain market participants are not part of forward clearing, non-standardised nature of most of the trades executed, etc. As such, it is recommended that the possibility of introducing an exclusive trading platform for forex forwards may be examined by March 2015 subject to standardisation of the instrument and trades attaining a critical mass.

4.4.3 *Forex Swaps:* Presently trading platform developed by CCIL and Reuters are available for trading in forex swaps. However, there is no regulatory requirement to mandatorily execute trades on any of these trading platforms. It is recommended that review regarding mandatory execution of trades in standardised forex swaps on the recognised trading platforms would be made by March 2015.

4.4.4 *Forex Option:* The product is not very standardised to be traded on an electronic trading platform. As forex options are highly customized, move to trading platform could be considered after the experience of mandatory trading platform for forex swaps and forwards. However, members agreed in principle to put in place a trading platform. It is recommended that the issue may be reviewed by March 2015.

4.4.5 *Currency Swaps, IRS in FCY, Interest Rate Option in FCY*: Market liquidity is not sufficient to consider setting up trading platforms. As market develops, possibility of introducing a trading platform would be examined at a later date.

4.4.6 *CDS:* Since there is no trading activity, trading platform has not been introduced. As market develops, possibility of introducing a trading platform would be examined.

4.5 *Margin requirements:*

4.5.1 *IRS:* IRS trades are presently not margined as per market practice. Therefore it is recommended that non-centrally cleared IRS trades (including client trades) should be subject to margin requirements. It is recommended that detailed modalities may be worked out in accordance with the recommendations of report of WGMR.

4.5.2 *Forex Forward:* International consensus is emerging that physically settled forex forwards and swaps may be exempted from initial margin requirement. It is recommended that the detailed modalities may be worked out as per recommendation of the report of WGMR.

4.5.3 *Forex Swap:* It was decided that the issue requires wider consultation before taking a call on prescribing variation margin requirement. Since the international commitment is to implement margin requirement by the year 2015, it is recommended that a wider market consultation may be held through Fixed Income Money Markets & Derivatives Association of India (FIMMDA) and Foreign Exchange Dealers' Association of India (FEDAI) and their views may be communicated to RBI.

4.5.4 *CDS*: Margin requirements have already been prescribed by RBI.

Conclusion

5. It can be seen from the above discussion that India is committed to adopting OTC derivatives reforms. However, the pace and scope of reform implementation depends on the domestic market conditions and characteristics. As issues like market liquidity, valuation norms, participants' sophistication in trading strategies, use of product as hedge etc. impact scope for standardisation and the adoption of central clearing, the roadmap for roll-out of reforms and their adoption must factor in these nuances. This is especially the case with markets like India, where in the OTC derivatives are simple products with low volumes. The Working Group is aware of these factors and accordingly recommended the roadmap with milestones. As some of the milestones are dependent on exogenous variables like improvement in liquidity, there is a possibility that the timelines may be revisited / revised based on developments in the OTC derivatives market. However, to clearly articulate our commitment to G-20 reform agenda and spell out path for implementation, it is recommended that the Working Group report which contains roadmap / timelines may be placed in public domain. Regulatory reform of OTC derivatives is very important from financial stability perspective. Therefore, all the stakeholders need to strive for implementation of the reforms as per the recommended roadmap to ensure a vibrant OTC derivatives market.

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Annex I

Summary of FSB Recommendations on OTC Derivatives Reforms

A. Increasing standardization

Standardization is a key condition for central clearing and trading on exchanges or electronic trading platforms, and also helps to facilitate greater market transparency. To promote the G-20's vision for greater use of these safer channels, authorities must ensure that appropriate incentives for market participants to use standardized products are in place. In particular, authorities should counter incentives that market participants may have to use non-standardized products solely to avoid central clearing and trading requirements. It is recommended:

1. Authorities should work with market participants to increase standardization of OTC derivatives products' contractual terms. In setting priorities for increased standardization of contractual terms, authorities should consider the systemic relevance of particular types of OTC derivatives products, including by assessing factors such as volumes and exposures.

2. Authorities should work with market participants to increase the proportion of the OTC derivatives markets that uses standardized operational processes and straight-through- processing. Greater use of standardized, automated processes will promote the use of standardized products.

3. To achieve increased standardization of contractual terms and greater use of standardized operational processes as set out in the above recommendations 1 and 2, the OTC Derivatives Supervisors Group (expanded to include relevant market regulators) (ODSG) should continue to secure ambitious commitments from the major OTC derivatives market participants.

4. Authorities should develop incentives and, where appropriate, regulation, to increase the use of standardized products and standardized processes. Authorities should examine new market activity on a regular basis to monitor the extent to which market participants may be trading non-standardized

contracts solely for the purpose of avoiding central clearing and trading requirements and take steps to address such behaviour.

B. Moving to central clearing

To help mitigate systemic risk in the OTC derivatives markets, the G-20 Leaders agreed that all standardized derivatives contracts should be cleared through central counterparties by end-2012 at the latest. They also agreed that non-centrally cleared contracts should be subject to higher capital requirements. In combination with setting mandatory clearing requirements and raising capital requirements for non-centrally cleared contracts to reflect their risks, including systemic risks, the use of central clearing should be expanded through industry commitments to increasing standardization and volumes of centrally cleared transactions (as addressed by recommendations 1 through 4 above). Increased standardization of contractual terms and operational processes should lead to greater liquidity and greater availability of reliable pricing data for such products, and thus a greater likelihood that a CCP can effectively risk manage them. For products that remain non-centrally cleared, authorities should set strengthened bilateral counterparty risk management requirements. It is recommended:

1. In determining whether an OTC derivative product is “standardized” and therefore suitable for central clearing, authorities should take into account (i) the degree of standardization of a product’s contractual terms and operational processes; (ii) the depth and liquidity of the market for the product in question; and (iii) the availability of fair, reliable and generally accepted pricing sources. In determining whether a mandatory clearing requirement should apply, authorities should consider whether the risk characteristics of the product can be measured, financially modeled, and managed by a CCP that has appropriate expertise.

2. Authorities should determine which products should be subject to a mandatory clearing obligation; however, they should not require a particular CCP to clear any product that it cannot risk-manage effectively, and should not mandate central clearing in circumstances that are not consistent with the G-20 objectives. When authorities determine that an OTC derivative product is standardised and

suitable for clearing, but no CCP is willing to clear that product, the authorities should investigate the reason for this. Subsequent to an investigation, if authorities determine there is insufficient justification for the lack of clearing, the authorities should take appropriate measures to promote central clearing. Such action could include creating incentives to encourage innovation by CCPs in a timely yet prudent manner or considering measures to limit or restrict trading in OTC derivatives

For products that are suitable for clearing but not centrally cleared:

3. For market participants to satisfy mandatory clearing requirements, access to CCPs (both direct and indirect, through client arrangements with direct participants) must be based on objective criteria that do not unfairly discriminate. Authorities should create a safe and sound environment for indirect access to clearing, and make any necessary proposals to change the legal framework and rules under which CCPs and market participants operate to achieve this. Authorities should monitor and, if detected, address unjustified impediments to indirect access. Authorities should require that CCPs and direct participants have effective arrangements in place that provide for the segregation and portability of customer positions and assets. In this context, authorities need to address the impact of insolvency laws and conflicts between insolvency laws that may arise in cross-border contexts.

4. Authorities should appropriately tailor any exemptions to mandatory clearing, and should not grant exemptions where doing so could create systemic risk. Authorities should actively monitor the use of any exemptions and review their appropriateness on a regular basis.

5. To help ensure a global regulatory level playing field and increase the safety of the financial system, CCPs that clear OTC derivatives should be subject to robust and consistently applied supervision and oversight on the basis of regulatory standards, that, at a minimum, meet evolving international standards developed jointly by CPSS and IOSCO.

6. Supervisors should apply prudential requirements that appropriately reflect the risks, including systemic risks, of non-centrally cleared OTC derivatives products, such as the reforms proposed by BCBS relating to higher capital requirements. In parallel, authorities should apply similar capital incentives to other financial institutions that trade OTC derivatives and are subject to capital regimes (such as broker-dealers and insurance companies). Authorities should consider whether measures other than capital incentives may be needed to encourage central clearing by market participants that are not subject to capital regimes (such as commercial entities or investors).
7. Recognizing that some portion of the OTC derivatives markets, including non-standardized derivatives, will remain non-centrally cleared, authorities must ensure that market participants have robust and resilient procedures in place to measure, monitor and mitigate counterparty credit and operational risks associated with non-centrally cleared contracts. Authorities should set and apply strong bilateral risk management standards, including collateralization, and require market participants to benchmark themselves against defined best practices. In this regard, the ODSG should continue to secure ambitious commitments from the major dealers for extensions of trade compression, dispute resolution, and portfolio reconciliation. Authorities should actively monitor the non-centrally cleared portion of the market to determine if additional or strengthened measures may be necessary.
8. To minimize the potential for regulatory arbitrage, IOSCO, working with other authorities as appropriate, should coordinate the application of central clearing requirements on a product and participant level, and any exemptions from them.

C. Promoting trading on exchanges or electronic trading platforms

The G-20 Leaders agreed that all standardized derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate. It may be appropriate to require trading of standardized derivatives on exchanges or electronic platforms where the market is sufficiently developed to make such trading practicable and where such trading furthers the objectives set forth by the G-20 Leaders and provides benefits incremental to those provided by standardization, central clearing and reporting of transactions to trade repositories. Also, increasing public price and volume transparency for all derivatives transactions, including non-standardized OTC transactions, should be explored. It is recommended:

1. IOSCO, with involvement of other appropriate authorities, should conduct an analysis by 31 January 2011 of: (i) the characteristics of the various exchanges and electronic platforms that could be used for derivatives trading; (ii) the characteristics of a market that make exchange or electronic platform trading practicable; (iii) the benefits and costs of increasing exchange or electronic platform trading, including identification of benefits that are incremental to those provided by increasing standardization, moving to central clearing and reporting to trade repositories; and (iv) the regulatory actions that may be advisable to shift trading to exchanges or electronic trading platforms.
2. Authorities should explore the benefits and costs of requiring public price and volume transparency of all trades, including for non-standardized or non-centrally cleared products that continue to be traded over-the-counter.

D. Reporting to trade repositories

G-20 Leaders agreed that OTC derivative contracts should be reported to trade repositories. By providing information to authorities, market participants and the public, trade repositories will be a vital source of increased transparency in the market, and support authorities in carrying out their responsibilities, including (i) assessing systemic risk and financial stability; (ii) conducting market surveillance and enforcement; (iii) supervising market participants; and (iv)conducting resolution activities. Trade repositories also can fulfill an important function as a source of data and downstream event processing services for market participants. It is recommended:

1. Authorities should ensure that trade repositories are established to collect, maintain, and report (publicly and to regulators) comprehensive data for all OTC derivative transactions regardless of whether transactions are ultimately centrally cleared. Authorities should establish a clear framework for the regulation of trade repositories based on their essential functions as a source of information to

authorities, market participants and the public. Trade repositories should be subject to robust and consistently applied supervision, oversight and regulatory standards that, at a minimum, meet evolving international standards developed jointly by CPSS and IOSCO.

2. Market regulators, central banks, prudential supervisors and resolution authorities must have effective and practical access to the data collected by trade repositories that they require to carry out their respective regulatory mandates. Access to trade repository information by official international financial institutions also should be permitted in appropriate form where consistent with their mandates.

3. In addition to current efforts to obtain client consents for regulatory reporting of relevant data, authorities should, where necessary, propose legislative measures to address legal barriers to data collection and dissemination by trade repositories. Authorities should ensure that appropriate dissemination and confidentiality arrangements are in place so that relevant authorities have full and timely access to the data relevant to their respective mandates.

4. Authorities must require market participants to report all OTC derivatives transactions, both centrally-cleared and non-centrally cleared, accurately and in a timely manner to trade repositories, or, in exceptional circumstances, to the relevant authority if it is not possible to report a particular transaction to a trade repository. Where transactions are centrally cleared or otherwise terminated early, reporting to trade repositories also must capture and preserve information on the original terms of the transaction.

5. Authorities with the legal mandate to set requirements for the reporting of transactions to trade repositories should consider the recommendations set out in the forthcoming report of the FSB Data Gaps and Systemic Linkages Group, and consult with the Committee on the Global Financial System (CGFS), the Bank for International Settlements (BIS), the ODSG and ODRF, to identify the data that should be reported to trade repositories to enable authorities to carry out their respective tasks and monitor, among other things, implementation of the

G-20 commitments to central clearing and exchange or electronic platform trading. Further, as the data must be able to be readily aggregated on a global basis, by end-2011 CPSS and IOSCO, in consultation with authorities, and with the ODRF, should develop both for market participants reporting to trade repositories and for trade repositories reporting to the public and to regulators: (i) minimum data reporting requirements and standardized formats, and (ii) the methodology and mechanism for the aggregation of data on a global basis.

E. Assessing progress and cooperating in OTC derivatives market reforms

Many OTC derivatives markets are global, with the same products traded in multiple jurisdictions and by multinational institutions. Given that these markets function on a cross-border basis, it is important that there is international cooperation and coordination to fulfill enforcement and supervision responsibilities, minimize the potential for regulatory arbitrage, and fully and consistently implement the G-20's commitments. We recommend the following to achieve these objectives:

1. The ODSG, working with the standard setters, the BIS, other relevant authorities and market participants, should develop appropriate reporting metrics to measure to what extent the recommendations of this report, and more generally, the G-20 commitments to central clearing, exchange or electronic platform trading, and reporting to trade repositories, are being met. These metrics should be developed, and necessary data identified, on a timeline that will enable the FSB to assess implementation status as of the end-2012 deadline.

2. Authorities should continue to use, promote, and where necessary, develop bilateral or multilateral arrangements to facilitate consultation, cooperation and the exchange of information concerning OTC derivatives markets and participants among all relevant authorities across financial sectors. Authorities should ensure appropriate coordination for the mandatory clearing of OTC derivatives contracts involving parties or instruments in multiple jurisdictions and ensure such contracts are appropriately reported to trade repositories. In addition, the ODRF, working with CPSS and IOSCO, should continue to foster development of common frameworks for effective cooperation and coordination

on oversight arrangements and information sharing among the relevant authorities for individual trade repositories and systemically important OTC derivatives CCPs.

Annex II

List of Members of the Working Group

Sr. No	Name	Designation	Chairman/Member
1	Shri R. Gandhi	ED, RBI	Chairman
2	Shri K.K.Vohra	PCGM, IDMD, RBI	Member
3	Shri Chandan Sinha	PCGM, DBOD, RBI	Member
4	Shri G.Mahalingam	PCGM, FMD, RBI	Member
5	Shri Vijay Chugh	CGM, DPSS, RBI	Member
6	Shri R.N.Kar	CGM, FED, RBI	Member
7	Ms. Rekha Warriar	CGM, FSU, RBI	Member
8	Shri K.Venugopal	CGM, SBI	Member
9	Shri R. Sridharan	MD, CCIL	Member
10	Shri C.E.S.Azariah	CEO, FIMMDA	Member
11	Ms. Shilpa Kumar	SGM, ICICI Bank	Member
12	Shri Hitendra Dave [Represented By Shri Manish Wadhavan]	MD, HSBC	Member

The Group acknowledges the active support provided by Shri N.R.V.V.M.K. Rajendra Kumar, GM, Internal Debt Management Department (IDMD). The Group also acknowledges the services of Ms. Nilima Ramteke, GM, Department of Payment and Settlement System, RBI, Ms. Dimple Bhandia, GM, Financial Stability Unit, RBI and Shri Sudarsana Sahoo, DGM, Financial Markets Department. The secretarial services were provided by Shri Vivek Singh, AGM, IDMD and Ms. Renuka Balakrishnan, Assistant, IDMD.

Annex III

Data related to OTC derivatives Markets

1. Forex OTC derivatives trade volumes

USD-INR Forwards (one side)

	No of Trades	**Volume (USD million)**	**Daily avg volume**
31-Jan-13	2,368	24,204	1,210
28-Feb-13	934	8,306	415
31-Mar-13	918	9,041	452
30-Apr-13	997	9,875	494
31-May-13	760	6,092	305
30-Jun-13	943	7,674	384
30-Jul-13	1,029	8,227	411

USD-INR Swaps (one side)

	No of Trades	Volume (USD million)	Daily avg volume
31-Jan-13	10,738	1,34,837	6,742
28-Feb-13	8,944	1,14,917	5,746
31-Mar-13	9,625	1,51,914	7,596
30-Apr-13	9,487	1,50,284	7,514
31-May-13	11,042	1,44,214	7,211
30-Jun-13	10,620	1,27,354	6,368
30-Jul-13	11,517	1,40,520	7,026

USD-INR Currency Options (one side)

	No of Trades	Volume (USD million)	Daily avg volume
31-Jan-13	308	1,861	93
28-Feb-13	289	2,469	123
31-Mar-13	169	1,458	73
30-Apr-13	389	2,818	141
31-May-13	512	3,281	164
30-Jun-13	397	2,413	121
30-Jul-13	379	1,737	87

20 working days assumed to arrive at daily average

2. Interest rate OTC derivatives trade volumes

Table 6: IRS Trade Summary

(Rs. in bn)

Period	MIBOR		MIFOR		INBMK		Total	
	Trades	Notional Amnt	Trades	Notional Amnt	Trades	Notional Amnt	Trades	Notional Amnt
2007-08	79495	47,281	18139	6,476	385	144	98019	53,901
	81.10%	87.72%	18.51%	12.01%	0.39%	0.27%		
2008-09	40912	26,448	4,799	2,237	132	66	45843	28,751
	89.24%	91.99%	10.47%	7.78%	0.29%	0.23%		
2009-10	20,352	14,521	1,050	539	77	51	21479	15,111
	94.75%	96.10%	4.89%	3.56%	0.36%	0.34%		
2010-11	33,057	23,597	1,291	749	150	88	34498	24,434
	95.82%	96.58%	3.74%	3.07%	0.43%	0.36%		
2011-12	33,642	24,510	2,101	1,100	14	9	35757	25,619
	94.09%	95.67%	5.88%	4.29%	0.04%	0.03%		
2012-13	22,713	20,216	1,252	754	11	6	23976	20,977

	94.73%	96.37%	5.22%	3.60%	0.05%	0.03%		

3. CDS Volumes

Period	Notional amount of Contract (Rs in Bn)
2010-11	0.1
2011-12	0.2

Appendix

Current status on OTC derivative products:

Product/G-20 requirements		Trade Repository (for both interbank and client trades)	Standardisation	Central Clearing (CCP)	Electronic trading platform	Higher capital /Margin requirements for non-centrally clearing OTC derivative trades
Interest Rate Derivatives	IRS	Available for both interbank and client trade	Partial- MIBOR standardised.	Non-guaranteed central clearing in place. CCP based clearing under consideration.	Not available. Electronic trading platform under consideration.	No margin requirement
Credit Derivative	CDS	Available for both interbank and client trades.	Standardised.	Not available.	Not available	Margin requirement in place
Forex OTC Derivatives	Forex forward	Available for both interbank and client trades (FCY -INR & FCY-FCY).	Not available as majority of interbank trades driven by customized client trades.	Guaranteed Central clearing available. RBI has not mandated it.	No exclusive platform available. Can be traded on FX- SWAP.	No regulatory requirement.
	Forex Swap	Available for both interbank and client trades (FCY -INR & FCY-FCY).	Not available as majority of interbank trades driven by customized client trades..	Guaranteed Central clearing available. RBI has not mandated it.	Can be traded on CCIL and Reuters' trading platform. Majority of trades done through brokers.	No regulatory requirement.
	Forex option	Available for both interbank and client trades (FCY -INR & FCY-FCY).	Not available as majority of interbank trades driven by customized client trades.	Central clearing not available.	Not available.	No regulatory requirement.
	Currency Swap	Available for both interbank and client trades (FCY -INR & FCY-FCY).	Not available.	Not available.	Not available.	No regulatory requirement.
	IRS in FCY	Available for both interbank and client trades.	Not available.	Not available.	Not available.	No regulatory requirement.
	IRS option in FCY	Not available due to negligible trading volume.	Not available.	Not available.	Not available.	No regulatory requirement.