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BY COURIER AND BY E-MAIL

8 March 2011

**Chief General Manager
Internal Debt Management Department
Reserve Bank of India
Central Office Building, 23rd floor
Shahid Bhagat Singh Marg
Mumbai – 400 001
INDIA
cgmimd@rbi.org.in**

Dear Madam,

DRAFT GUIDELINES ON CREDIT DEFAULT SWAPS FOR CORPORATE BONDS

ISDA and its members would first like to reiterate that we are very much in support of the introduction of credit derivatives in India. We are grateful for the opportunity to comment on the draft Guidelines and look forward to working with the Reserve Bank of India (“**RBI**”), the Fixed Income Money Market and Derivatives Association of India (“**FIMMDA**”) and market participants to ensure the successful launch and development of the credit derivatives market in India.

We have a number of substantive comments and queries on the draft Guidelines. Some of these have already been raised in our previous submission and we would ask RBI’s indulgence in this respect. We also have a number of technical drafting points which we set out in the attached Schedule.

1. Eligible Participants¹: We remain concerned that the market will not be sufficiently deep and liquid given the limited entities that are permitted to be Market-makers. We hope that RBI will re-consider allowing institutional investors (including Foreign Institutional Investors (FIIs)) that are allowed to buy and sell INR bonds, have a risk management policy and can provide

¹ Section 2.1.1 of the draft Guidelines.

collateral to be Market-makers. We also ask RBI to re-consider allowing unlisted corporates of a certain size and unlisted subsidiaries and affiliates of listed corporates to be Users.

2. Reference Obligation²: With regard to the CDS with a User, we seek RBI's clarification of whether the Credit Event must occur with respect to the Reference Obligation itself before the CDS can be triggered. We also seek RBI's confirmation that in a CDS between two Market-makers, the parties are free to agree that the CDS can be triggered by a Credit Event that occurs with regard to Obligations other than the Reference Obligation and that the Deliverable Obligations can be other than the Reference Obligation. We would also request clarification of the purpose behind the requirement in Section 2.4(iv) for the "eligible underlying" (which we understand refers to the Reference Obligation) to be "reviewed periodically". In the typical CDS contract, the Reference Obligation may be substituted only in circumstances such as where it is redeemed earlier than provided for in the bond terms or it ceases to be the valid and binding obligation of the Reference Entity (see Section 2.30 of the ISDA Credit Derivatives Definitions).

3. Unscheduled redemption (in whole or part) of the Reference Obligation: Sometimes, there may be an unscheduled early redemption (in whole or part) of a bond or the bond may cease to be the obligation of the Reference Entity. The ISDA Credit Derivatives Definitions provides (in Section 2.30) for the Calculation Agent to identify a Substitute Reference Obligation in such a case. We assume that this would be the appropriate course of action in a CDS between two Market-makers. However, this would not appear to be appropriate in a CDS with a User and we seek RBI's confirmation that it would require the CDS (or the proportionate part thereof) to be unwound without payment (since the value of the unwound CDS would be zero) in such an event.

4. Listed corporate bonds³: It is possible that a bond may cease to be listed. We seek RBI's confirmation that the listing requirement applies only at the point of entry into the CDS and that unwinding of the CDS would not be required if the bond should subsequently cease to be listed. In addition, in relation to the rating requirement for unlisted bonds of infrastructure companies, we seek RBI's confirmation that the rating requirement applies only at the point of entry into the CDS and that unwinding of the CDS would not be required if the bond should subsequently cease to be rated.

5. Tenor and CDS standardization⁴: In the global market, standardized CDS trades with standard protection periods and coupon payment dates that coincide with the IMM roll dates of March 20, June 20, September 20 and December 20. To achieve CDS standardization in the Indian market, it would be necessary to allow Users to buy CDS that would expire on the standard roll dates. It is likely that the standard roll dates will not coincide with the maturity date of the bonds held by the Users. Thus, we ask RBI to re-consider the condition in Section 2.5.1 of the draft Guidelines that Users cannot buy CDS for periods longer than the tenor of the bonds held by them. We request RBI to allow Users to buy CDS that would expire on the standard roll date immediately following the maturity date of the relevant bond.

² Section 2.4 of the draft Guidelines.

³ Section 2.4 of the draft Guidelines.

⁴ Sections 2.5.1 and 2.10 of the draft Guidelines.

6. Unwinding of CDS position by Users⁵: We note with gratitude that RBI has taken on board our previous submission to allow a User who ceases to hold the underlying bond to sell (subject to the consent of the original protection seller) the CDS to the purchaser of the underlying bond. We ask RBI to re-consider allowing the User to sell the CDS to another Market-maker as well as the bond purchaser. It may not be possible for the User to sell the CDS to the bond purchaser as the bond purchaser may not be eligible to be a User. Even where the bond purchaser may qualify as a User, the original protection seller may also not consent to a transfer to the bond purchaser (for example, where the original protection seller does not have credit limits for the bond purchaser). Further, although Section 2.6.1 requires the User to unwind the CDS within 5 business days of selling the underlying bond, there may be cases of recalcitrant Users who fail to do so and the Market-maker may discover this only some time after the event. We seek RBI's confirmation that in such cases, the unwind price must be that prevailing at the time of discovery by the Market-maker (and not that prevailing at the time of sale of the bond or 5 business days thereafter).

7. Market-makers' duty to verify underlying exposure⁶: Section 2.5.3 requires the User to submit to the Market-maker an auditor's certificate that it holds the underlying bond when it enters into or unwinds the CDS. In addition to an auditor's certificate, we submit that a custodian's certificate or such other evidence as may reasonably be acceptable to the Market-maker should also be acceptable. We seek RBI's confirmation that the Market-maker need only verify that the User holds the underlying bond at the point of entry into and unwinding of the CDS, i.e., that the Market-maker need not make such enquiries during the life of the CDS. In addition, notwithstanding its contractual representations and undertakings to the Market-maker, you may have a recalcitrant User who fails to unwind his CDS position within 5 business days after selling the bond or fails to provide the requisite evidence of bond-holding within the time-frame allowed. It would discourage such actions by Users if RBI were to stipulate in the Guidelines, for example, that in such a situation, the User must unwind only with the original protection seller at the market price prevailing at the point of unwinding, with any profits to be retained by the protection seller while losses must be made good by the User.

8. Exclusion of zero coupon bonds, amortizing bonds and callable/puttable bonds⁷: We would appreciate RBI's clarification of the rationale for these types of bonds to be excluded as Reference Obligations and Deliverable Obligations.

9. Prohibition of CDS on interest receivables⁸: We are not sure what this is intended to cover and would appreciate RBI's clarification of the meaning as well as the rationale for the prohibition.

10. Documentation⁹: In our previous submission, in relation to CDS with Users, we had highlighted the risk of re-characterization as an insurance contract. This risk cannot be removed

⁵ Section 2.6 of the draft Guidelines.

⁶ Section 2.5.3 of the draft Guidelines.

⁷ Section 2.8(v) of the draft Guidelines.

⁸ Section 2.8(vi) of the draft Guidelines.

⁹ Section 2.9 of the draft Guidelines.

by drafting of the documents. We would request RBI to stipulate that a Market-maker need not be licensed and regulated as an insurance company.

11. Restructuring¹⁰: We request RBI to re-consider allowing Restructuring as a Credit Event. Basel II requires that the Credit Events include “restructuring of the underlying obligation involving forgiveness or postponement of principal, interest or fees that results in a credit loss event (i.e. charge-off, specific provision or other similar debit to the profit and loss account)”. Where restructuring is not included, only partial recognition of 60% is allowed. Given that they can (at best) get a 60% offset only, Users may conclude that the economics of buying protection without Restructuring do not make sense (since the price with or without Restructuring is not likely to be significantly different).

12. Computation of Credit Exposure to Individual/Group Borrowers¹¹: In addition to the single/group exposure limits, we request RBI’s clarification as to the applicability of other prudential exposure limits such as capital market exposure, real estate exposure, NBFC exposure, para banking limits, etc.

13. Collateralisation and Margining¹²: We reiterate that where there is a broader trading relationship between the parties, it should be the net exposure across all the transactions and not just the CDS transactions that should be margined.


14. Looking ahead into the future: We urge RBI to be open to re-considering the market infrastructure as the market develops beyond INR-denominated and settled CDS on INR domestic bonds. There is an established infrastructure (ISDA’s Determinations Committees, CCPs and trade warehouse) in the global CDS market and RBI should at least weigh the pros and cons of leveraging this global infrastructure as compared to developing its own domestic infrastructure.

We look forward to continuing to work with RBI, FIMMDA and market participants in launching and developing the credit derivatives market in India. Please do not hesitate to contact Mr Keith Noyes (knoyes@isda.org) at +852 2200 5909 or Ms Jacqueline Low (jlow@isda.org) at +65 6538 3879.

Yours faithfully,

For the International Swaps and Derivatives Association, Inc.


Keith Noyes
Regional Director, Asia Pacific


Jacqueline Low
Senior Counsel Asia

¹⁰ Section 2.11.1 of the draft Guidelines.
¹¹ Section 3.1.2.2 of the draft Guidelines.
¹² Section 3.1.3 of the draft Guidelines.

SCHEDULE

2.4(ii) ... Besides, unlisted/unrated bonds issued by the SPVs (which shall be the reference entity) set up by infrastructure companies are also eligible as reference obligation.

2.4(v) Further, *protection sellers* should ensure not to sell protection on reference entities/obligations on which there are regulatory restrictions on assuming exposures in the cash market such as, the restriction against banks holding unrated bonds, single/group exposure limits and any other specific restriction imposed by the regulators from time to time in relation to *protection sellers*.

2.5.3 ... Further, the *users* are required to submit an auditor's certificate to the *protection sellers*, of having the underlying bond while entering into/unwinding the CDS contract (or in the case where the CDS is unwound after the bond sale, of the date on which the underlying bond was sold).

2.6.2 ... While unwinding, the protection seller may also ensure that the transaction is done at transparent arm's length market price.

2.9 FIMMDA, in association with ISDA, shall devise a standard confirmation to be used in conjunction with the ISDA Master Agreement for Indian CDS.

2.11.1 The Credit Events for the CDS in India shall be on the lines of the definitions as provided in the 2003 ISDA Credit Derivatives Definitions (read with the ~~ISDA March 2009 and ISDA July 2009 supplements~~), as modified by FIMMDA, in association with ISDA, the Determination Committee in consonance with the Indian Laws.

2.11.2 ... Further, the definition of various credit events should be clearly defined in the bilateral confirmation to be used in conjunction with the ISDA Master Agreement prepared by FIMMDA, in association with ISDA, to avoid any confusion.

2.12.2 For *users*, physical settlement is mandatory. ~~In case of auction-based settlement, physical settlement for users would take place at a price decided through auction.~~
[Note: In the case of physical settlement, the User will deliver the bond and receive the face value of the bond from the Market-maker – the auction price is irrelevant.]

3.1.2.1(a) ... The maximum counterparty exposure for the protection seller is the amount of any unpaid premiums, which does not change, and the mark-to-market value of the CDS.

3.1.7 Before actually undertaking CDS transactions, participants shall put in place a written policy on CDS which should be approved by their respective Board of Directors or equivalent body.

Annex CDS Form I: 5th column - Settlement (eCash/Physical/Auction)