

Reserve Bank of India delivers Yet another draft of Credit Derivatives Guidelines

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The Reserve Bank of India (RBI) came up with a draft of guidelines on credit derivatives in March 2003. The Governor's credit policy in April this year stated that the RBI will introduce credit derivatives in India in a calibrated manner and that the RBI will come with guidelines by 15th May 2007. On the 16th May 2007, the RBI posted yet another draft of the guidelines for public comments.

Between March 2003 and May 2007, more than 4 years have elapsed and there are several developments that speak aloud of the opportunities that we have missed. One, during this time, the global credit derivatives volume zoomed from USD 2.2 trillion (end 2002) to USD 34 trillion (end 2006) – a growth of nearly 1600%. Credit derivatives are today the fastest growing segment of the OTC derivatives market. Two, almost every country that one can compare India with has had full fledged regulatory rules on credit derivatives for quite sometime now. Three, several Indian names are traded on a regular basis in global credit derivatives markets and two Indian names are a part of a popular traded credit derivatives called iTraxx Asia ex-Japan. In absence of the regulations locally, several banks have been forced to export out their credit derivatives business with reference to Indian names through their overseas subsidiaries. There have, in fact, been some synthetic CDOs with all Indian names. Fourth, the global market has come a long way from the bilateral credit default swaps – today, the market is abuzz with hundreds of thousands of trades in index tranches, which is a pool of synthetic exposures on selected names in different countries and different geographies.

Let no one make the mistake of believing that India lacks knowhow or expertise to handle credit derivatives. Anyone who knows the derivatives market would agree that World-over, credit derivatives desks in most global investment banks are manned by Indians. In addition, several of the large credit derivatives dealers, investors and hedge funds have exported out credit derivatives pricing and administration to India. Hence, a large part of the USD 34 trillion trade is somehow or the other stationed in Bombay or Bangalore.

In short, for no particular reason, India has delayed the introduction of credit derivatives.

Regrettably, after all these years, the RBI has come up with guidelines which are limited to single name credit default swaps, and that too, strictly on hedging basis. It is an undeniable fact today, banks and dealers do not use credit derivatives merely for hedging – it is more often than not a device for creating exposures. If this is just the beginning, one would understand it, albeit with the comment that the beginning quite late, and quite diffident.

Quick understanding of the credit derivatives market:

ISDA's estimate of credit derivatives volume end-2006 was USD 34.5 trillion, growing roughly at the rate of over 100% per annum. Credit derivatives emerged practically around 1993-4, but were hardly known until 1995-6. They really shot into fame when some smart banks demonstrated ability to shed risk during the 1997 Asian crisis, Russian crisis and so on. The shot in arm was the bankruptcy of Enron.

Contrary to popular perception, credit derivatives are not typically linked to default of a particular loan, but a credit event referenced to a particular entity. Take the case of the most common product – a credit default swap (CDS). For instance, if a protection buyer (PB) and protection seller (PS) trade on a reference entity X, X need not be on the books of PB. In addition, the trade is mostly referenced to generic credit risk or risk of default of entity X, and a generically defined “loan or bond” is made the reference obligation for this purpose. In other words, the derivative is a stand-alone independent transaction between PB and PS and it is not necessary for PB to link it with an actual exposure in X. PB uses the CDS as a device of shorting a credit asset, and PS uses the contract as a device for long a credit asset. In other words, the credit risk itself becomes a commodity – similar to equities, bonds or other securities of the reference entity.

From the plain-vanilla single name credit default, the market saw gradual progression to basket default swaps and portfolio default swaps. If the portfolio swap is linked with a diversified portfolio, it becomes possible to create multiple tranches – say 0-3% tranche, 3-7% tranche and so on. The tranches take different layers of risk in the pool of credit exposures. These are known as **synthetic CDOs**.

A synthetic CDO is self-made pool of credits, but the market was looking for more standardised pools of credits which would allow the players to take a view on the corporate sector as a whole. Hence, came the **index trades** – the indices currently traded are sets of North American names called CDX.NA and European and Asian names called iTraxx. It is after the introduction of the index trades that the market took a real leap, since the indices allow the dealers to trade in direction of credit risk, correlation, delta, recovery rates, and so on. One may note from the following table from the British Bankers Association that index trades are the fastest growing segment of the credit derivatives business:

Type	2000	2002	2004	2006
Basket products	6.0%	6.0%	4.0%	1.8%
Credit linked notes	10.0%	8.0%	6.0%	3.1%
Credit spread options	5.0%	5.0%	2.0%	1.3%
Equity linked credit products	n/a	n/a	1.0%	0.4%
Full index trades	n/a	n/a	9.0%	30.1%
Single-name credit default swaps	38.0%	45.0%	51.0%	32.9%
Swaptions	n/a	n/a	1.0%	0.8%
Synthetic CDOs – full capital	n/a	n/a	6.0%	3.7%
Synthetic CDOs – partial capital	n/a	n/a	10.0%	12.6%
Tranched index trades	n/a	n/a	2.0%	7.6%
Others	41.0%	36.0%	8.0%	5.7%

Are credit derivatives used mainly for hedging? Like in case of all derivatives, a credit derivative is a synthetic replication of a credit exposure. For instance an interest rate swap may be used either for hedging interest rate risk, or for taking an exposure on interest rates. Likewise, credit derivatives may be used for shedding risk, or for taking risk. Given the ever-increasing role of hedge funds and other yield-hungry investors in the credit derivatives market today, it is quite evident that most trades are used for yield kicking, making trading gains and arbitrage than for hedging.

The RBI guidelines – statutory basis:

The Guidelines are proposed to be issued as mandatory guidelines to regulated institutions under the Banking Regulation Act. A question is - would these guidelines have the impact of limiting the credit derivatives market to banks only? Is there something that makes credit derivatives illegal, except where they are in accordance with the Guidelines?

The Reserve Bank of India (Amendment) Act 2006 inserted sec. 45V in the Reserve Bank of India Act which states that notwithstanding anything contained in the Securities Contracts (Regulation) Act, 1956, or any other law for the time being in force, transactions in such derivatives, as may be specified by the Bank from time to time, shall be valid, if at least one of the parties to the transaction is the Bank, a scheduled bank, or such other agency falling under the regulatory purview of the Bank as the RBI may specify. It was explained in the explanatory memorandum that this section was needed to clarify the legality of derivatives in India. It is not a concluded issue that derivatives are not legal in India if this section was not there – there might be doubts, as there have been doubts in several other countries too, as to whether derivatives fall foul of the gaming or gambling restrictions. In this author's view, the enactment of the above provision was

only clarificatory – to render certainty to the legality of derivatives. However, there is no global bar on a derivative transaction as such.

Therefore, while derivative transactions by banks will surely have to abide by the Guidelines, it is the opinion of the author that derivative trades by others are not proscribed and do not have to be in accordance with the guidelines.

Permitted credit derivative trades:

As the RBI proposes to permit credit derivatives trades on a calibrated basis, it has, for the time being, made a very narrow niche for credit derivatives to start in India. As stated before, the market is essentially motivated by arbitrage and trading motive – so limiting it to hedging purpose neither makes enough of a motivation to initiate the trades, nor would it be practical to limit it to hedging – as commented below.

Para 1.6.1 says that the protection buyer must have a credit exposure in order for it to buy protection. Assume PB has bought protection from PS – so PS now synthetically has acquired a credit exposure. Needless to say, PS may now enter into an offsetting credit default with PS2, and may be motivated to do so if the CDS spreads have widened. The second CDS may be viewed as either a hedge or as a trading deal. If the second type of CDS is permitted, there is no reason why PS may buy protection from PS2 first, and then sell protection to PB, as the economic impact of the changed sequence is really no different. In addition, the Guidelines has elaborate rules about the trading book treatment for credit derivatives – the trading book treatment by definition means the transaction was not meant to be a hedge.

The Guidelines limit CDS trades to:

- Transactions referenced to resident entities only;
- Transactions where protection buyers and protection sellers are both resident;
- Transactions where the reference entity is a rated entity;

Clause 1.4.2 of the Guidelines providing that the reference obligation shall be identical with the underlying exposure held by the PB is obviously erroneous – first, maturity matching is never possible nor intended in case of credit derivatives. PB might have 38 months left for an exposure, but the standard CDS term is 1 year, 3 years, 5 years and 10 years. A CDS is different from a guarantee –and the very reason for the difference is that a CDS is not explicitly linked with the actual exposure held by the PB. In fact, later part of the Guidelines [Para 4.4.5] explicitly deals with maturity mismatches.

Clause 1.4.4 states that the CDS contract shall not have a materiality threshold. Materiality threshold is the minimum amount of loss that the PB must suffer in order to make a claim against the PS. That is to say, a first loss upto the materiality threshold is taken by the PB itself. Materiality threshold is most common in CDS contracts. From regulatory capital perspective, global regulations, including Basle II provide for a capital consequence of materiality threshold –that an amount equal to materiality threshold will be deducted from the regulatory capital of the bank – but never put a straight bar on such a provision, which is anyway most common. As a general rule, the role of banking

regulators is not to police the trades by direct intervention or prescription, but to lay down capital consequences.

The Guidelines have expressly permitted three modes of settlement – physical, cash and binary. The last of the settlement mode is though becoming increasingly common, but is mostly not accepted for regulatory capital purposes as the fixed recovery agreed upon does not necessarily provide adequate hedge.

Synthetic securitisation: a missed opportunity:

It has been the consistent view of this author that with the stamp duty and mortgage registration difficulties affecting securitisation transactions in India, synthetic securitisation provides a much more convenient alternative. Synthetic securitisations use credit derivatives to synthetically transfer assets, instead of using the true sale route.

With credit derivatives guidelines being put in place, it was hoped that it would be possible to use the synthetic securitisation mode in India. That would have also opened up tremendous potential for synthetic CDOs referenced to Indian entities, which are currently forcefully being exported out of India. However, as the guidelines have remained limited to single name credit default swaps, they have completely missed the potential for synthetic securitisation.