

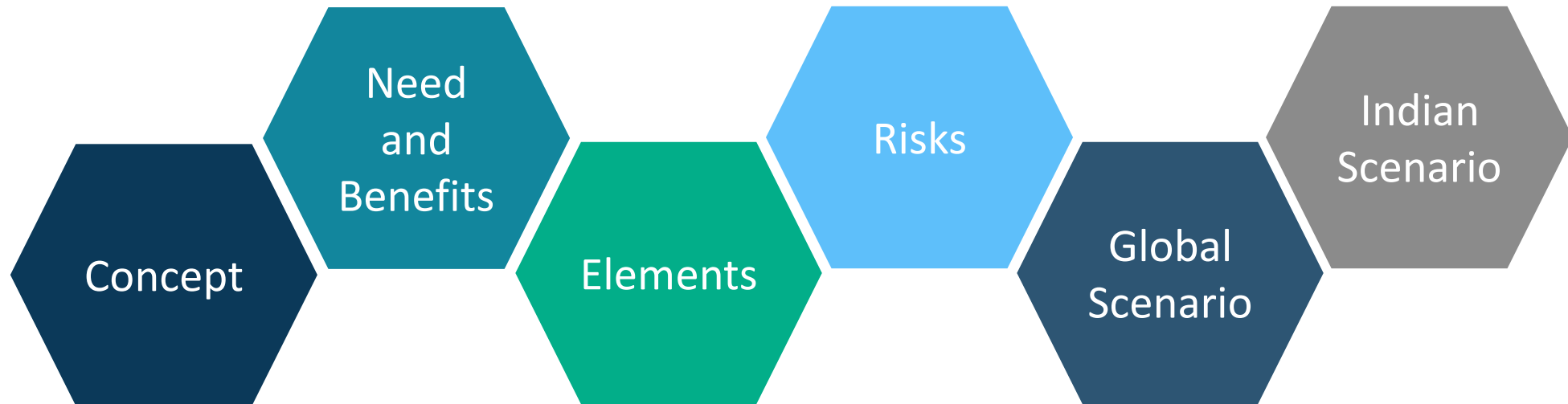


CREDIT DEFAULT SWAPS

(Global And Indian Scenario)

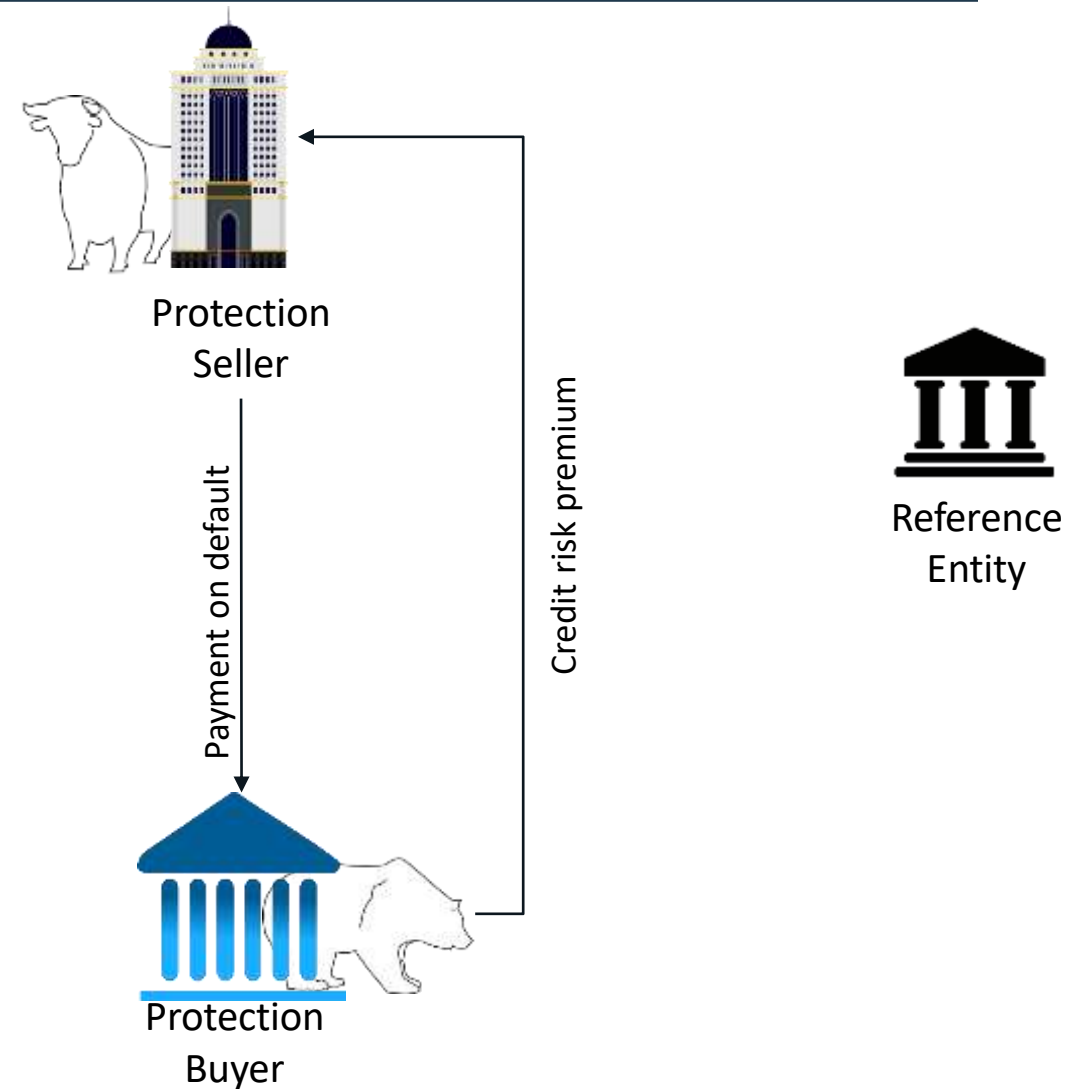
-Kanakprabha Jethani

Learning Objective



What is a CDS?

- A type of credit derivative
- Synthetic trading of credit risk of a Reference Entity (RE)
- Ultimately, trading in risk of bankruptcy of RE
- A contract between two parties
 - 1 party- undertakes to bear the risk of a credit default of a party in exchange of a risk premium
 - Another party sells the risk
 - Parties may or may not have an exposure in reference entity/obligation
- Parties
 - Protection buyer- usually banks, financial institutions etc. who possess the risk
 - Protection seller- such as hedge funds, insurers etc. having appetite for risk



Why CDS?

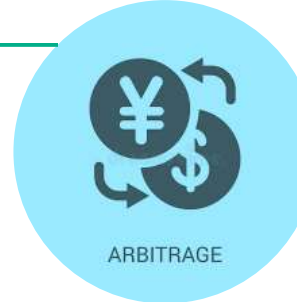
Hedging credit risk

Primary purpose for which CDSs were introduced



Arbitrage Benefit

Negative correlation between credibility and CDS spread



Market Making

Trade in securities market + CDS



New Asset classes

Synthetic creation of assets which was otherwise not possible



Trading

Also known as Naked CDS- No risk possession



Regulatory Capital Management

Exposures for which Protection has been bought, are not considered for computing capital adequacy



Diversification

Creation on synthetic assets



Common Elements of CDS

Notional Value

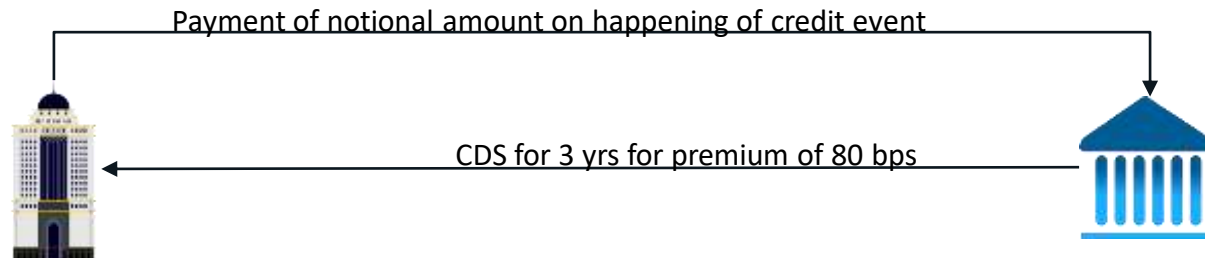
- Credit risk on an entity- no specific bonds/loans
 - hence, important to determine tradeable value
- Helps in determining risk premium and protection payment
- Standard value- USD 1 million

Premium

- Consideration for PS
- Expressed in bps
- Priced based on the risk and probability of default
- Accrues daily
- Usually settled quarterly

Tenure

- Term for which the CDS will provide protection
- CDS contract ends at the end of tenure or happening of credit event
- Does not necessarily coincide with maturity of reference obligation
 - In case capital relief is required, maturity is to match.



Credit Event

- Pre-determined events, on happening of which, PS pays protection payment
- ISDA defined 7 credit events
- May be other events as well

Settlement

- Final payout
- May be cash/physical
- Physical- possible for naked CDS

What is a Credit Event?



Bankruptcy



Failure to Pay



Repudiation/Moratorium



Restructuring



Obligation Acceleration



Obligation Default



Government Bail-in

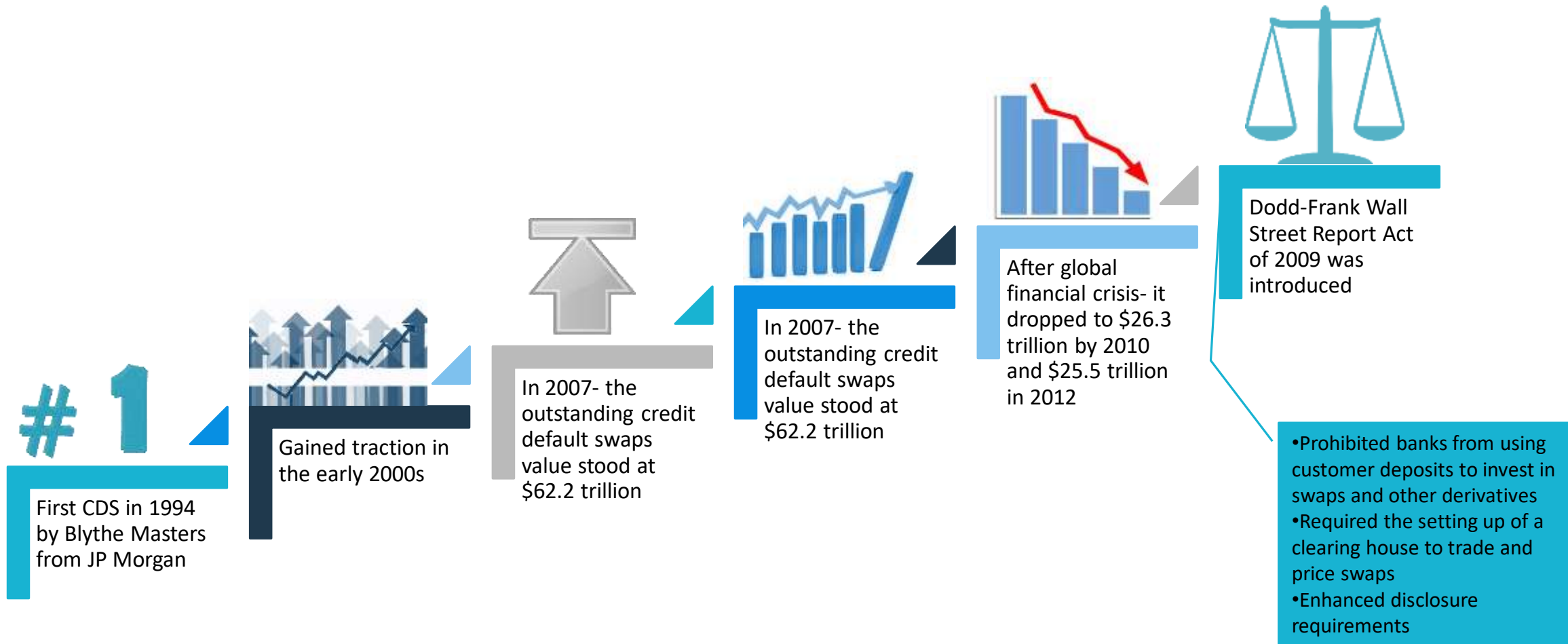
Risks in CDS



- Lack of Transparency
 - Difficult to find out in whose hands the risk lands
 - Concentration risks may be enhanced
 - If residing with unregulated- difficult to monitor
- Transfer of the risks to less informed
- Excess Leverage
- Riskier Lending

Global Scenario

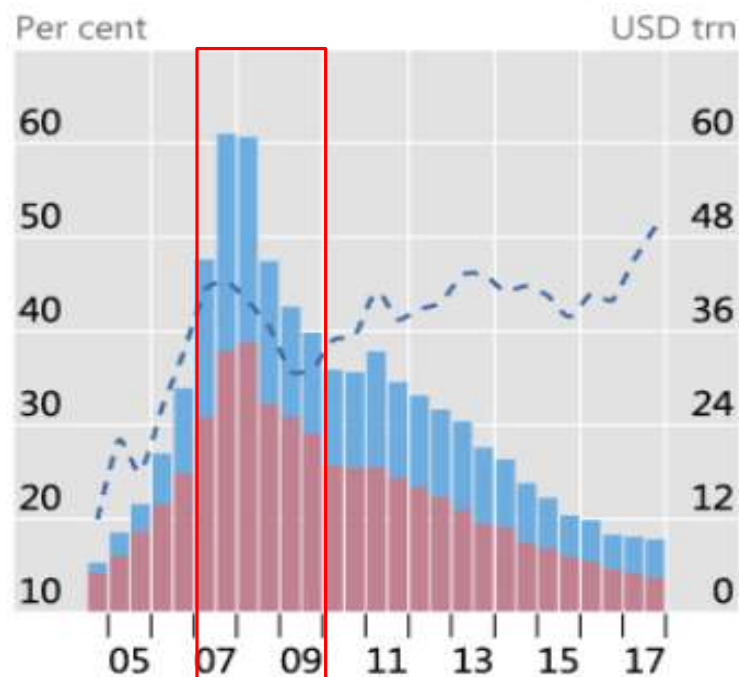
History and Journey



CDS: Pre and Post Global Financial Crisis

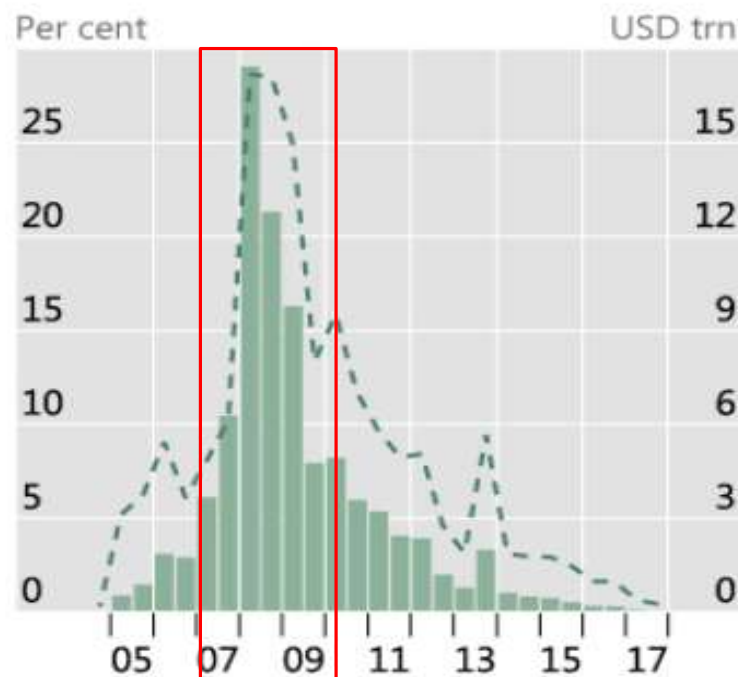
Credit default swaps: market overview

Notional amounts outstanding¹



Lhs: - - - Multi-name (share of total)
Rhs: ■ Single-name
■ Multi-name²

Compression³



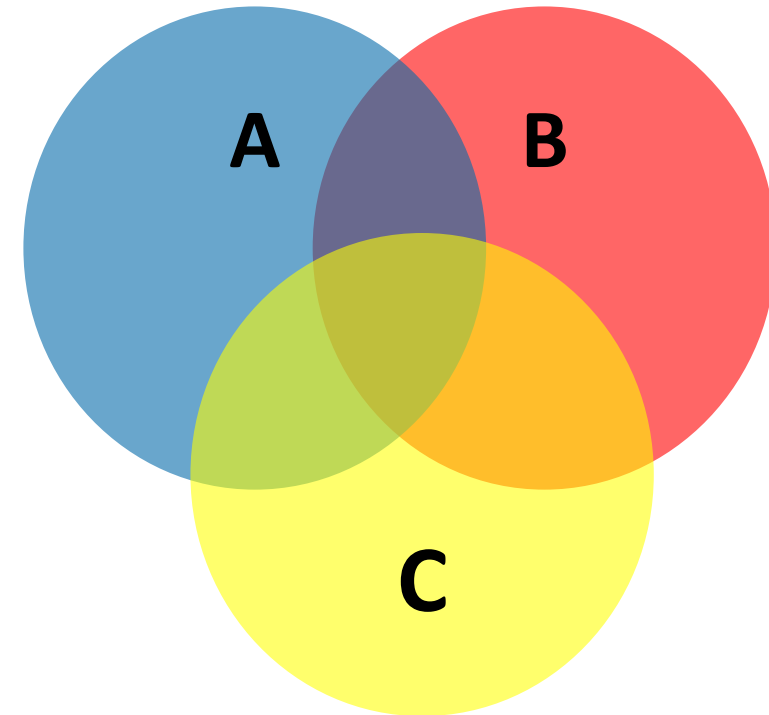
- - - As a share of outstanding notional (lhs)⁴
■ Compression volumes (rhs)

Source: BIS: The credit default swap market: what a difference a decade makes, 2017

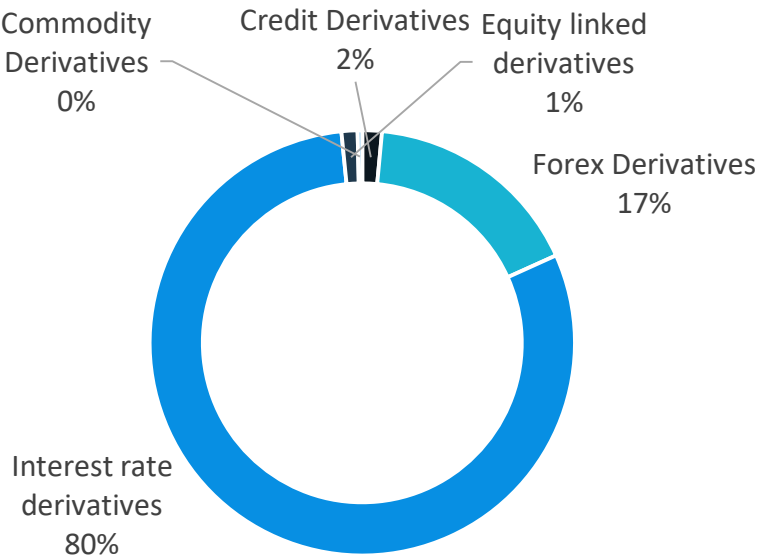
Prevalent Structures

- Single Name
 - Specific Reference Entity such as a bank, individual, corporate
- Basket CDS- A customized portfolio of reference entities
 - First-to-default CDS
 - Loss of protection seller limited to first default in the basket
 - Second-to-default CDS
 - Loss of protection seller limited to second default in the basket
 - Nth-to-default CDS
 - Loss of protection seller limited to nth default (pre-decided number)
 - Full basket CDS
 - Exposure of protection seller on the entire basket
 - Tranching (Synthetic CDO)
 - Risks tranching based on appetite and return expected
 - PS may take exposure on a specific layer- say 5-10%
- Index CDS
 - Entities underlying an index are reference entities
 - Based on correlation of entities

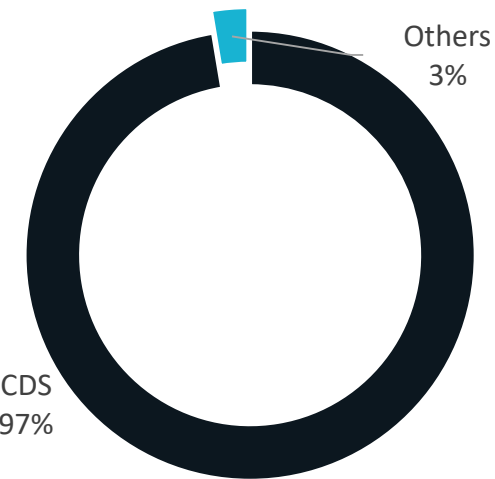
Pricing of Basket/ Index CDS



Credit Derivatives as a part of OTC Derivatives Market



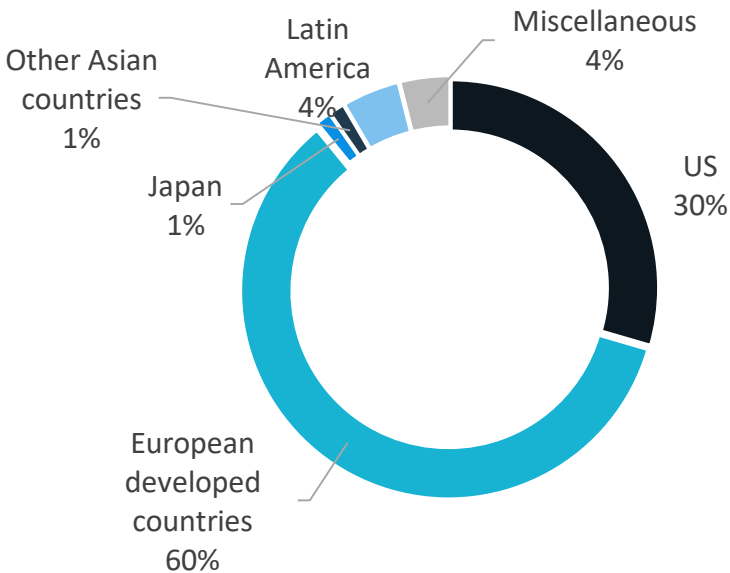
OTC Credit Derivative Transactions



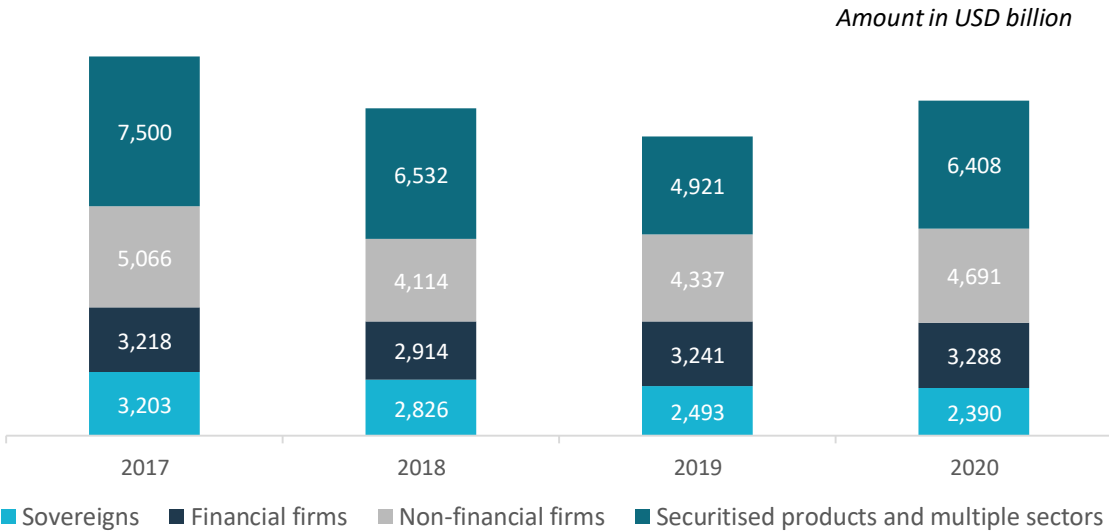
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Region-wise Distribution



Reference Entities



Recent Developments

1 **\$600-700**
(in billions)
Quarterly transaction volume
each quarter over 13 quarters
upto June 2019

3 **500**
Dealers
45% transactions by 27 of
them

2 **1284**
unique reference entities
recorded

4 **5**
Indices amount for more
than 90% of Index CDS

Global Legislations

US

Dodd-Frank Wall Street Reform Act of 2009

- Operational requirements
- Margin requirements
- Position Limits
- Recordkeeping and Reporting Requirements
- Establishment of a central clearing
- Registration requirements
- Standards for business conduct

Capital Requirements

- For unregulated swap dealers and participants
 - minimum amount of adjusted net capital that is equal to or greater than the highest of:
 - \$ 20 million, plus the market risk and credit risk exposures
 - 8% uncleared swap margin
 - Statutory requirement, or requirement of any associations, if any

EUROPEAN COUNTRIES

EU Short Selling Regulation (236/2012)

- Applicable on all member countries
- Bars having uncovered position in sovereign CDS- speculative
 - No restriction on other reference entities
- Above restrictions may be suspended for market making
- Power to restrict/limit CDS transactions based on market movement
- Uncovered positions in CDS required to be reported

ISDA Guidelines

- International Swaps and Derivatives Association
- Global financial trade association
 - established to standardize documentation for the derivatives markets
 - fosters efficient derivatives markets to facilitate effective risk management
- No regulatory recognition
- Created Master Agreement format- to be used in CDS transactions
- Preparation of protocols for dealing in CDS
 - Definition of credit events
 - Maintenance of margins
 - Clearing protocols
- Determination of happening of a credit event through a Determinations committee

Regulatory Capital Relief under Basel Norms

- Basel norms provide for capital relief to the extent the exposure is hedged
 - It states- *In case of Banking Book positions hedged by bought CDS positions no exposure will be reckoned against the reference entity / underlying asset in respect of the hedged exposure, and exposure will be deemed to have been substituted by the protection seller*
- Conditions to be satisfied:
 - Risk weight applicable to the protection seller to be lower than that of the underlying asset
 - No asset/maturity mismatch between the underlying asset and the reference / deliverable obligation
 - Asset mismatch- if secured asset owned but CDS on unsecured
 - Maturity mismatch
 - Agreement to be irrevocable
- In case conditions are not met- capital adequacy requirements as applicable to the underlying asset shall be applicable
- For a protection seller
 - Risk weights as applicable to the protection buyer- had the protection not been bought, shall be applicable
- What happens in case of naked CDS?
 - Protection buyer- does not have actual exposure- hence no question of adequacy
 - Protection seller- must treat as if there is an actual exposure

Indian Scenario

Guidelines for CDS for Corporate Bonds

- No guidelines for CDS of other debt obligations
 - Sellers can be Commercial Banks, NBFC-SIs, standalone PDs etc.
 - NBFC directions state- NBFCs can only be buyers
 - Buyers can be
 - Commercial Banks, NBFCs, Mutual Funds, Insurance Companies, HFCs, Provident Funds, Listed Corporates, Foreign Institutional Investors (FIIs)
 - At least one of the parties to be RBI regulated
 - Similar conditions as Basel
 - Provides for regulatory capital relief
 - Reporting requirements
 - Quarterly reporting to RBI
 - Disclosure requirements
 - In notes to accounts
- 2011
 - Only hedging allowed
 - On listed corporate bonds
 - 2013
 - CDS permitted on unlisted but rated bonds- for issuers other than infra companies
 - No minimum rating specified
 - CDS on securities with maturity upto 1 years- CPs, Certificate of Deposits

Draft Reserve Bank of India (Credit Derivatives) Directions, 2021

- Permitted products

- Only single named CDS
- Structured financial product with a credit derivative as one of the components or as an underlying not allowed

- Eligible reference obligations

- Commercial Paper, Certificates of Deposit, NCDs of original maturity upto one year, rated bonds and unrated INR bonds issued by the Special Purpose Vehicles set up by infrastructure companies.
- In demat form
- ABS/MBS, structured obligations, etc. not allowed.
- Compared to global scenario- where the reference entities are securitisation products in majority of CDS transactions

- Market maker

- Banks, NBFCs, SPDs, NHB, SIDBI, NABARD, Exim Bank
- Allowed to buy protection even if underlying exposure is not owned

- Users

- Non-retail-
 - Hedging and trading
 - insurance co, pension funds, mutual funds, AIFs, SPDs, NBFCs and companies with NOF of Rs. 500 cr or more, FPIs
- Retail- others
 - Only hedging
 - Only physical settlement

- Protection Seller

- Insurance co, pension funds, mutual funds, AIFs, FPIs

- Restrictions

- Involvement of related parties
- Eligibility to deal in cash market

- Standardisation

- FIMMDA to devise master agreement, premiums, calculation methodology, standard maturity, premium payment dates etc.

Draft Reserve Bank of India (Credit Derivatives) Directions, 2021

- CDS Contract
 - Mention details of RE, RO, credit event, method and procedure of settlement.
 - Represent a direct claim on the protection seller
 - Not allow PS to unilaterally cancel except in case of a default by PB
 - No clause to prevent PS from making the credit event payment
 - PS not to have any recourse to PB for credit event losses
- Reporting
 - Market-makers to report CDS transactions within 30 minutes of the transaction, to CCIL
 - clearly indicate whether hedging or other purposes
 - Assignment to be reported to CCIL
- Exchange traded CDS
 - Exchanges may offer standardised single-name CDS contracts with guaranteed cash settlement.
 - Prior approval of the RBI before finalising or modifying the product design, eligible participants and other details of CDS contracts.
 - FPIs may transact
 - Exchanges to report all CDS transactions to the trade repository and RBI
- Credit Derivatives Determinations Committee
 - FIMMDA to set up
 - consisting of market participants , representatives of central counterparties and legal/consultancy firms
 - FIMMDA to establish the rules for governing
 - Committee to make determinations regarding key terms of contract including credit event
 - Develop standard procedures for determining the reference price for cash settlement of CDS contracts.
 - May conduct an auction to determine the reference price for cash settlement of CDS contracts
 - Decisions shall be binding on the market participants

Thank you!