Update

RBI's Guidelines on Credit Default Swaps for Corporate Bonds

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Update

Reserve Bank of India recently published the final guidelines on Credit Default Swap for Corporate Bonds in May, 2011 which places the operational framework for introduction of plain vanilla OTC single name CDSs for corporate bonds in India.
The highlights of the guidelines are:

- **Guidelines for Users and Market Makers -** Users can buy protection for hedging purposes only. Holding short positions in CDS contracts and selling protection is not permitted. Users can exit bought positions by unwinding them with the original counterparty or by assigning in favor of the buyer of underlying bond. Offsetting of bought position with a sale contract is not permissible. Only market makers can buy protection without having the underlying bond.
- Users cannot buy CDS for an amount higher than that of corporate bonds or for a tenor greater than corporate bonds held by them
- Users are required to submit an auditor's certificate or custodian's certificate to the protection sellers or novating users, of having the underlying bond while entering into/unwinding the CDS contract
- CSD trades shall have atleast one RBI regulated entity on one side of the transaction. CDS transactions cannot be between related parties or where the reference entity is a related party to either of the contracting parties.
- **Reference entity** – Reference entity should be a single legal resident entity, users and market makers to be resident entities as well. FIIs are an exception to the list.
- **Reference Obligation** – The reference obligation would be:
  - listed corporate bonds
  - unlisted but rated bonds of infrastructure companies
  - unlisted/unrated bonds issued by the SPVs set up by infrastructure companies
- **Prohibitions on writing a CDS –**
  - Obligations such as asset-backed securities/mortgage-backed securities (structured financial products), convertible bonds and bonds with call/put options shall not be permitted as reference and deliverable obligations
  - CDS cannot be written on interest receivables or on securities with original maturity upto 1 year
  - Dealing in derivative products with CDS itself as an underlying is not permissible

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- **Other operational issues –**
    - CDS contract is irrevocable except in circumstances of protection buyer defaulting under the terms of the contract and CDS contracts should be a direct claim on the protection seller and the protection seller shall not have a recourse to the protection buyer for credit event losses.
    - Settlement methodologies for the CDS transactions shall be determined upfront and would be determined in the CDS documentation and for transactions involving users physical settlement would be mandantory.
    - The protection sellers will have limits on the exposure in single entities and aggregate of individual gross position in relation to their capital funds.

The idea of introducing CDS for corporate bonds is to provide a tool for redistribution of risk. CDSs enhance investments and borrowing opportunities, reducing transaction cost, hiving credit risk so as to increase the interest of the investors' in corporate bonds that would lead to the development of the corporate bond market in India.
The text of the guidelines is available here.