# Basics of Credit Default Swaps

*Credit Default Swaps are being introduced in India. Reserve Bank of India's final guidelines on credit default swaps (CDS) for corporate bonds are effective from 24 October 2011. CDS are a new financial product being introduced in India for the first time.*

## 1. What is the background to the introduction of CDS?

Originally, RBI intended to introduce this new financial product in 2003 and 2007, but could not introduce it at that time. Subsequently, RBI had set up a working group for introduction of CDS in 2010. Based on the recommendations of the working group and the feedback received on draft guidelines, Reserve Bank of India issued the final guidelines on 23 May 2011 for effective implementation of CDS from 24 October 2011.

## 2. What is the rationale behind the introduction of CDS in India?

With the introduction of the final guidelines, RBI wants to further deepen and widen the corporate bond market in India. It is expected that banks and other financial institutions in India will be able to transfer and manage the credit risk in a better manner with the help of CDS. Credit default swaps earned bad name during the global financial crisis of 2007/2008 as the US and European banks took higher risks and suffered heavy losses on account of their huge exposure in the CDS market.

Despite the global financial crisis of 2007/2008 and the latest sovereign debt crisis that is sweeping the world right now, Reserve Bank of India has been bold enough to introduce new financial products in India as part of financial sector liberalization in India. In the last three years, RBI has introduced a slew of products ranging from currency futures, currency options to interest rate futures and now CDS market is at our doorstep.

## 3. What are CDS or Credit Default Swaps?

CDS are conceptually similar to an insurance policy. Like in an insurance policy, in CDS there is a protection buyer who purchases protection (for a premium) or cover against credit risk of a specific asset. If the protection buyer suffers any loss on the asset, the protection seller will make payment to the protection buyer.

It is like buying an insurance product in the sense that CDS are a form of insurance against credit risk. It is a tool to transfer and manage credit risk in an effective manner through redistribution of risk.

Simply speaking, CDS are:

- similar to an insurance policy for credit enhancement
- a risk management tool for credit protection (buying protection against credit risk)
- considered as a cover basically against default by debtors

A credit default swap is a contract between two parties in which one party named protection buyer makes a series of payments to another party named protection seller and in exchange the protection buyer will receive payment if a credit event on a reference obligation occurs as specified in the contract and within the stipulated time.

The cost of buying protection against credit risk is called premium, which is expressed in basis points per annum (one per cent is equal to 100 basis points).

## 4. What are the benefits of CDS?

Banks and other financial institutions in India are big lenders to companies, firms and others. As such, the credit risk for banks goes up if the borrowers do not repay their debts in time or there is a risk of default. Now, the introduction of CDS will provide an additional avenue for lenders to manage their credit risk and help free up capital.

Banks and financial institutions are bound by RBI's prudential norms on lending to large companies and large group of companies. Several times, banks exceed the RBI's lending ceilings to large companies. In such cases, banks can use CDS to bring down their credit exposure to such companies.

Mutual funds and insurance companies may also participate in CDS market as a means to diversify their portfolio and broaden their asset base.

## 5. Who can participate in the CDS market?

Basically, there are two types of participants in the CDS market. They are market makers and users:

1. **Market makers:** These are entities permitted to quote both buy and/or sell CDS spreads. They would be permitted to buy credit protection without having the underlying bond.

2. **Users:** These are entities permitted to buy credit protection (buy CDS contracts) only to hedge their underlying credit risk on corporate bonds.

## 6. Which are the entities eligible to become market makers & users?

As of now, RBI has permitted the following participants in the CDS market:

| Market makers | Users |
|---|---|
| Commercial banks<br>Stand-alone primary dealers<br>Non-Banking Financial Companies (NBFCs) | Commercial banks<br>Primary dealers<br>Non-Banking Financial Companies (NBFCs)<br>Mutual Funds<br>Insurance companies<br>Housing Finance companies<br>Provident funds<br>Listed corporates<br>Foreign Institutional Investors |

*Note: Insurance Companies and Mutual Funds would be allowed to act as market-makers subject to the approval of their respective regulators.*

## 7. What are the salient features of the CDS final guidelines?

- The final guidelines issued by RBI are for Plain Vanilla Over-The-Counter Single-name CDS for corporate bonds in India
- All CDS trades shall have an RBI regulated entity at least on one side of the transaction
- **Reference entities:** CDS will be allowed only on listed corporate bonds as reference obligations. The reference entities shall be single legal resident entities.
- The users (except FIIs) and market makers shall be resident entities
- The reference asset/obligation and the deliverable asset/obligation shall be to a resident and denominated in Indian Rupees
- The CDS contract shall be denominated and settled in Indian Rupees
- The CDS contract shall be irrevocable
- CDS shall not be written on securities with original maturity of up to one year, for example, Commercial Papers (CPs), Certificate of Deposits (CDs) and Non-Convertible Debentures (NCDs) with original maturity up to one year
- **Standardised CDS contracts:** The CDS contracts shall be standardised.
- **Settlement Methods:** For transactions involving users, physical settlement is mandatory. For other transactions, market makers can opt for any of the three settlement methods (physical, cash or auction settlement), provided the CDS documentation envisages such settlement.
- **Eligible credit events:** Bankruptcy, Failure to pay, Repudiation/moratorium, Obligation acceleration, Obligation default, Restructuring approved under Board for Industrial and Financial Reconstruction (BIFR) and Corporate Debt Restructuring (CDR) mechanism and corporate bond restructuring are the eligible credit events for CDS.

## 8. What are the risks pertaining to CDS?

CDS are an off-balance sheet exposure to both credit and market risk. The sale of CDS amounts to assuming credit risk. A CDS contract creates two types of exposures for the parties concerned, namely, counterparty credit exposure and market risk exposure.

RBI's approach to the introduction of CDS is very cautious due to the role played by CDS in the collapse of Lehman Brothers in 2008 and the subsequent global financial crisis. RBI's final guidelines are extremely elaborate and they are allowing only plain vanilla single-name CDS and that too for only corporate bonds that are listed on exchanges.

## 9. Conclusion

Currency futures as a financial product are a big success in India with the high-volume trades being done on NSE, MCX-SX and USE. However, the interest rate futures market is still in its infancy even after two years of launch. For any market to be successful, liquidity is very crucial and so is number of players from various sections. The Indian corporate bond market is not very active. It remains to be seen whether CDS market in India will repeat the success of currency futures market.