Draft directions on credit derivatives by RBI

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In news

Recently, the RBI has released draft directions on credit derivatives

Key directions of RBI

The RBI has come up with 'Reserve Bank of India (Credit Derivatives) Directions, 2021 – Draft' as development of CDS market is sine qua non for the development of a liquid market for corporate bonds, especially for the bonds of lower rated issuers.

According to RBI, Credit Default Swap(CDS) contracts can only be based on a debt instrument issued by a single entity, and the underlying for a CDS cannot be another credit derivative.

Permitted debt instruments are:

- commercial papers and certificates of deposit of maturity up to one yea
- rated corporate bonds, and
- unrated bonds of infrastructure companies

These derivative contracts may be traded on a stock exchange or in the over-the-counter (OTC) market

Participants:

- The counterparty to every CDS transaction must be an entity authorised by RBI for this purpose or a market-maker.
- Market-makers are entities that buy and sell CDS contracts to provide liquidity to the market.

- All retail and non-retail users may buy a CDS, however, only certain non-retail users can sell a CDS.
- Such non-retail users include insurance companies, pension funds, and mutual funds, among other institutions.
- Retail users are only permitted to buy CDS for hedging purposes. Hedging is the use of a derivative instrument to reduce the credit risk of an underlying debt instrument.

Standardisation:

- As per the directives the Fixed Income Money Market and Derivatives Association of India will devise a standard master agreement for all CDS contracts, and conventions for the pricing of CDS contracts.
- Sellers using their own pricing methodology must disclose the rationale for doing so, and explain the changes.

What is a credit derivative?

A credit derivative is a derivative contract where the underlying is a debt instrument.

What is a credit default swap (CDS)?

It is a kind of credit derivative. In a CDS contract, the seller of the CDS commits to compensate the buyer of the CDS in case of an adverse event (such as default) related to the underlying debt instrument.

CDS is a credit derivative contract in which one counterparty (protection seller) commits to compensate the other counterparty (protection buyer) for the loss in the value of an underlying debt instrument resulting from a credit event with respect to a reference entity.

CDS is a tool to transfer and manage credit risk in an effective manner through redistribution of risk

What is the over-the-counter (OTC) market?

An over-the-counter (OTC) market is a decentralized market in which market participants trade stocks, commodities, currencies, or other instruments directly between two parties and without a central exchange or broker. Over-the-counter markets do not have physical locations; instead, trading is conducted electronically.