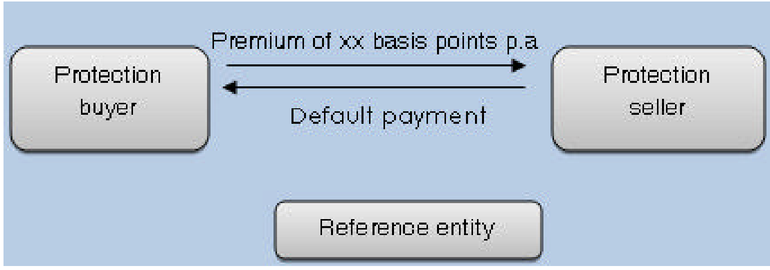
Credit Default Swap (CDS): An Indian Perspective and Road Ahead

Sidharth Rath
President-Head Treasury & TXB
Axis Bank Ltd.

What is CDS?

A CDS is a contractual agreement that transfers the default risk of one or more reference entities from one party to the other. One party, the protection buyer, pays a periodic fee to the other party, the protection seller, during the term of the CDS. If the reference entity defaults or declares bankruptcy or another credit event occurs, the protection seller is obligated to compensate the protection buyer for the loss by means of a specified settlement procedure. The protection buyer is entitled to protection on a specified face value, referred to as the notional amount, of reference entity debt. Each individual contract lays out the specific terms of their agreement including identifying the underlying asset (loan or bond) and what constitutes a credit event.



CDS is mainly used for the purpose of hedging and speculation.

History of CDS

First trade of CDS was carried by banks trust in 1991, but J.P. Morgan bank is widely credited with creating modern day credit default swap in 1995. In that instance, J.P. Morgan closed what's widely acknowledged as the first CDS trade by buying protection from the EBRD on the corporation Exxon corporation after the Exxon Valdez oil disaster spiked failure concerns on the world's second largest oil company.

During 1995-1999, all major Wall Street and London dealing houses created their first CDS desks and market saw the first basket trade in 1998. During 2000-2003, single name CDS were quoted across the capital structure and Rating spectrum. Bank Traders, Hedge funds and Insurers dominated the CDS markets with minimal participation from Mutual funds, Pension funds, corporates etc. However, during the Lehman crisis, the CDS market faced significant issues and losses. Major reason were the 'insurance' being higher than the outstanding value of assets insured and reduction of asset values in liquidity crisis. As in December 2014, the gross notional amount of CDS contracts worldwide was US$ 16399 billion (source –BIS)

In addition to single name CDS, there were a few indices including Markit, iTTRAXX, Fitch and S&P indices which had become popular during 2003-2008 period.

ISDA (International Swaps and Derivatives Association) provides definitions of derivative products and credit events and the ISDA master agreement is typically used between derivatives dealers for OTC (over the counter) trades.

Despite the concerns & financial troubles in European and other developed markets in 2008, credit default swaps have proved to be a useful portfolio management and speculation tool, and is likely to remain an important and critical part of the financial markets

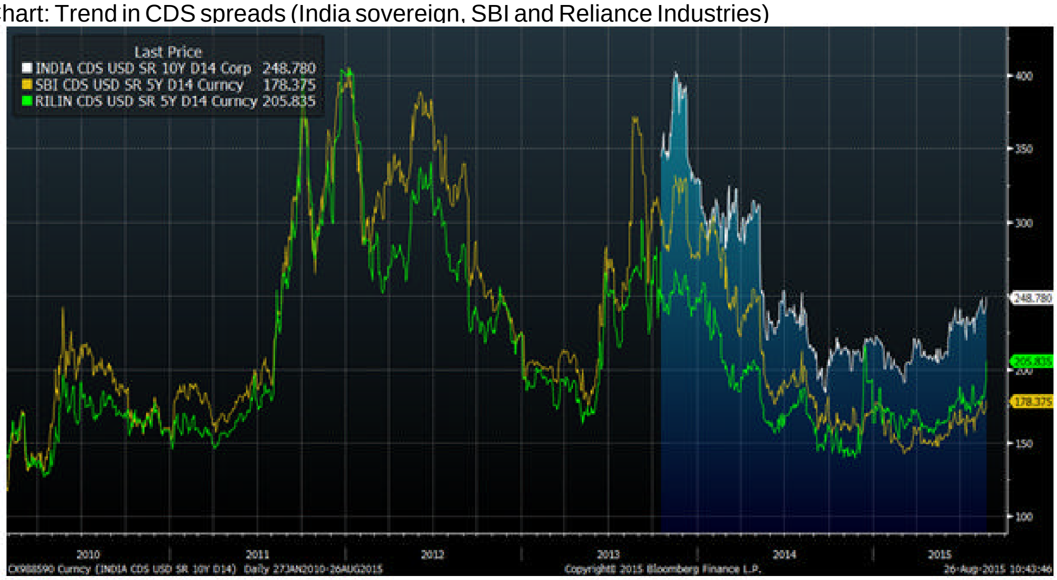
CDS market structure in India

The CDS market structure of any country includes sovereign spread and single name CDS for corporates/banks.

	International market (USD)		Domestic market (INR)	
Sovereign CDS	✓		NA	
Indices	X		X	
Corporate CDS	✓	Reliance Tata motors Bharti Airtel NTPC, IRFC, PFC	✓	Only 2 trades in December 2011
Bank CDS	✓	ICICI SBI, BOI EXIM	X	

Although sovereign CDS spreads are available for India, liquidity is limited. USD CDS spreads are available for few of the Indian corporates and banks, which are fairly liquid.

Chart: Trend in CDS spreads (India sovereign, SBI and Reliance Industries)



Source: Bloomberg

CDS in India

RBI published first CDS guideline on 23 May, 2011 to introduce plain vanilla OTC single name CDS for corporate bonds in India from October, 2011.

- RBI allowed market makers including Commercial Banks, standalone Primary Dealers (PDs), NBFCs to quote both buy and sell CDS spreads, even without having the underlying bond.
- Users, who could buy CDS contracts only to hedge their underlying credit risk on corporate bonds included Commercial Banks, PDs, NBFCs, Mutual funds, Insurance companies, Provident funds, Listed corporates, FIIs etc.
- CDS was allowed only on listed corporate bonds as reference obligations. However, unlisted but rated bonds of infrastructure companies were also allowed.
- A CDS position can be closed only through un-winding and not by undertaking off-setting position.

Revised guidelines on CDS were published by RBI on 7 January, 2013 where the RBI allowed:

- unlisted but rated corporate bonds even other than infrastructure companies
- securities with original maturity up to one year like Commercial Papers, Certificate of Deposits and Non-Convertible Debentures
- to unwind CDS bought position with original protection seller at FIMMDA price or mutually agreeable price.

Why CDS is needed?

CDS is a way to hedge the underlying credit risk of corporate bond. India has a large corporate bond market, the size of which has grown at a multiple of 8x in the last decade. Issuances have increased from INR 55,409 crores in FY 2005 to INR 4,32,691 crores in FY 2015, with above 60% in AAA rated segment.

CDS can act as a market booster for corporate bonds by effectively hedging the underlying credit risk freeing up capital of banks and other financial institutions. Development of a CDS market may lead to a gradual deepening of the corporate bond market as CDSs can enhance the bond market investors' appetite for lower rated issuers, beyond their traditional favourites in the high-safety category.

Issues relating to the Indian CDS market

Indian market saw the first INR denominated CDS trades in December 2011 with two deals of Rural Electrification Corporation (REC) and Indian Railway Finance Corporation (IRFC) covering Rs 5 crores each. These deals were between ICICI Bank and IDBI Bank. The RBI has since then allowed banks to begin hedging their banking and trading books using CDS, signalling that the infrastructure is in place.

The key issues which are specific to Indian CDS market are:

- Only banks, PDs and financially strong NBFCs can sell protection, while FIIs and Hedge funds which typically have a big appetite for credit risk are not allowed to sell protection in India.
- The user cannot buy CDS for amounts higher than the face value of corporate bonds. No user can maintain naked CDS protection, i.e. CDS position without any underlying bonds.
- Although RBI has allowed insurance companies and mutual funds to be sellers, this is subject to IRDA and SEBI permitting them. This is not likely until the market develops somewhat.
- Entities permitted to quote both buy and sell CDS spreads need a minimum CAR (Capital Adequacy Ratio) of 11% and net NPA of < 3%.
- There are not much incentives for Banks and other market players to buy/sell CDS as majority of Indian corporate bonds are AAA rated.
- CDS is mainly an OTC product and the parties have to agree upon the terms & conditions of the CDS individually.
- For transactions involving users, physical settlement is mandatory.
- Market-makers shall report their CDS trades with both users/investors and other market-makers on the reporting platform of CDS trade repository within 30 minutes from the deal time. The users would be required to affirm or reject their trade already reported by the market- maker by the end of the day.

How to develop CDS market in India?

The RBI in 2008 had planned to introduce the CDS for corporate bonds, but postponed the move in view of the global financial crisis, which was caused by large scale trading in such debt & derivative instruments. The experience gathered during the crisis significantly contributed to a better understanding of the market of credit default swaps. Though the move of RBI to introduce CDS in India was much awaited and a welcome move, the market is yet to pick up.

Incentivise the market makers:

Given the cash credit system in India, lower rated corporates generally do not prefer the bond route. Given the nature of corporate debt market, where majority of the bonds are AAA rated, banks do not have much incentive to do CDS.

The regulators viz RBI , SEBI and IRDA would need to look at the CDS market in a holistic manner and consider to incentivise market participants including Banks to undertake CDS transactions by way of

(i) lower capital requirements; the provision requirements for the underlying asset may be reduced
(ii) No reserve requirements for the funding of the bond against which CDS is provided. IRDA and SEBI also may provide relief to the participants (Insurance Companies and Mutual Funds) undertaking CDS etc.

Foreign investors typically invest in AA+ and above rated papers. Allowing them to undertake both buy and sell CDS would help to develop both the CDS and corporate bond market.

Asset reconstruction companies can also be allowed to sell protection, given their expertise in credit

Retrial funds in India cannot invest in credit papers below AA unless they buy protection on the underlying paper. With CDS, they can generate better returns by investing in lower rated corporate bonds with the credit risk hedged. This will help to develop this market.

Trading platform and settlement:

CDS also should be done on an online trading platform with a central clearing agency like CCIL/NSE/BSE. CCIL has already initiated trading platform for OIS (Overnight Indexed Swap) trading, which can be replicated for CDS.

For CDS transactions, the margins would be maintained by the individual market participants. Participants may maintain margins in cash or Government securities.

Standardized documentation:

The CDS contracts needs be standardized. The standardisation of CDS contracts can be achieved in terms of coupon, coupon payment dates, etc. This will guard against customized contracts wherein the market-makers and users are free to determine the terms.

CDS may also be allowed in USD, in addition to the currently allowed INR.

Conclusion

The vast majority of the Indian corporate debt market consists of bonds issued by public sector banks and quasi government entities. The rest comprises mostly of debt from high investment-grade corporate borrowers where the motivation of the bondholder to buy CDS protection is low. The volume of medium to low investment-grade corporate bonds in India is insignificant but the availability of CDS protection may help it grow substantially.

RBI has allowed dealing in CDS for unlisted bonds, rather than only on the listed ones. A coordinated action by the other regulators can allow insurance companies, pension funds, and provident funds to also participate in this space through the CDS route.

Incentives to market makers, allowing FIIs, standardised documentations and contracts, electronic trading platform against margin are a few of the important steps for developing the CDS market.

Increased use of CDS, over the medium term, has the potential to impart additional liquidity to the bond markets, which have so far been predominantly illiquid. It will help lower rated borrowers diversify their funding sources by accessing the bond markets. CDS also holds promise of providing a thrust to the much-needed infrastructure financing through the corporate bond route in India. CDS & development of corporate debt market will go hand-in- hand and will complement each other.