Credit derivatives – Can India learn from the mistakes of others?

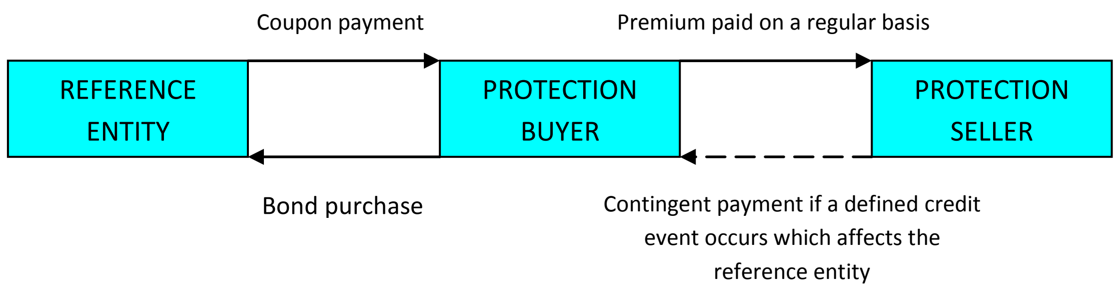
By Namita Sharma

Credit derivatives will be introduced from November, 2011 in India in the form of plain vanilla single name credit default swaps (‘CDS’) for corporate bonds[1].

What are Credit Derivatives?

Credit derivatives isolate and separate credit risk[2] from market risk, allowing credit risk to be hedged, traded or transferred[3]. They efficiently distribute credit risk across the market; help institutions meet risk management objectives and preserve customer relationships whilst complying with regulations/laws (e.g. capital adequacy requirements). The most common product is a CDS.

In a CDS, a **protection buyer** pays a **protection seller** a regular premium (similar to an insurance premium) in order to transfer exposure to a **reference entity**’s[4] credit risk. If a contractually defined **credit event**[5] occurs, affecting the reference entity, the protection seller makes a contingent payment to the protection buyer.



Controversy surrounding Credit Derivatives

Over the last decade or so, certain financial products and markets have been embroiled in controversy. Complex structured products like collateralised debt obligations (‘CDOs’) have made credit risk assessment much more difficult. Further, as secondary markets have developed, protection sellers have gained more bargaining power, and trading has become more speculative, unlike the original products where end users were genuinely hedging against credit risk of counterparties. Consequently, moral hazard increased as can be seen in the key roles these products played in the US sub-prime mortgage crisis, the collapse of Lehman Bros and the fact that they have been linked by some[6] with the Greek sovereign debt crisis.

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[1] As set out in the Reserve Bank of India’s Guidelines on Credit Default Swaps for Corporate Bonds, RBI/2010-11/542, dated 24th May, 2011 & RBI’s communication dated 20-10-2011.
[2] Credit risk is risk of default or non-payment on a bond, loan or contractual product like a swap.
[3] As defined in “Mastering Derivatives Markets” by Francesca Taylor, p 229.
[4] E.g. a bond issuer, where protection buyer is a bond holder.
[5] E.g. bankruptcy, failure to pay, debt restructuring, obligation acceleration or default and repudiation/moratorium.
[6] Notably Angela Merkel, the German Chancellor. However, many others have refuted the role of credit derivatives in the Greek crisis.

There has been abundant international credit derivative related litigation. Matters dealt with have ranged from insolvency law issues, to breach of contract claims, where parties have disputed certain defined terms (e.g. reference entity, credit event), and consequently protection buyers have sought to enforce contracts[7]. Cases involving exotic products (CDOs and CDO2s) have arisen when claimants, upon market fluctuations, lost huge amounts of money from these products. They argued that there was inequality of bargaining powers and sophistication of the parties from the outset, and that they did not understand the possible losses they could incur. Claimants argued that their more sophisticated counterparties owed a duty of care which was breached, or they negligently/fraudulently misrepresented as to the possible downsides of the products[8].

It is clear from international case law (and also from Indian jurisprudence with regard other derivatives products[9]) that where parties are relatively sophisticated commercial entities, it is difficult to successfully bring a claim of misrepresentation, breach of duty, or other related claims in a similar vein where it is argued that there was an inequality of bargaining power, unless if fraud can be proved.

Credit Derivatives in India

The salient features of the products being introduced in India, as set out in the RBI's Guidelines on Credit Derivatives for Corporate Bonds, are:

- CDSs will be permitted where the reference entities are listed corporate bonds, unlisted but rated bonds of infrastructure companies or unlisted/unrated bonds issued by the Special Purpose Vehicles (SPVs) set up by infrastructure companies.
- Only single legal resident reference entities are allowed, and they must also be the **direct obligor** for the reference asset/obligation and the deliverable asset/obligation.
- Market participants are delineated into categories of market makers and users.
- Market makers are permitted to both buy and/or sell CDS protection. They would be permitted to buy protection without having an underlying risk on a corporate bond (i.e. even if they are not bondholders). Market maker participants include Commercial Banks, Non Banking Financial Companies (NBFCs), and standalone Primary Dealers, subject to satisfying the prescribed eligibility norms. Insurance companies and Mutual Funds would be allowed to act as market-makers subject to the approval of their respective regulators.
- Users are permitted to only buy credit protection, in order to hedge their underlying risk on corporate bonds. They are not permitted to sell protection/hold short positions. However, they are able to exit their bought CDS positions by unwinding them with the original counterparty or by assigning/novating them in favour of a buyer of the underlying bond. User participants include Commercial Banks, NBFCs, Primary Dealers, Mutual Funds, Insurance Companies, Housing Finance Companies, Provident Funds, Foreign Institutional Investors and listed corporates.

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[7] E.g. see cases such as *Ursa Minor Ltd v Aon Fin. Products Inc* WL 1010278 (SDNY 2000), *Aon Fin Prods Inc v Société Générale* 476 F3d 90 (2d Cir 2007), *Deutsche Bank AG Ambac Credit Prods* LLC 2006 WL 1867974 (SDNY 2006).

[8] E.g. see *Cassa di Risparmio della Repubblica di San Marino SpA v Barclays Bank Ltd* [2011] EWHC 484 (Comm).

[9] See *Rajshree Sugars & Chemical Ltd v AXIS Bank Ltd* - 2008 Indlaw MAD 4314

- All CDS trades must have an RBI regulated entity on at least one side of the transaction.
- Standardised contractual documentation as set out by FIMMDA[10] will be used, though the products are OTC and contractual terms can be negotiated.

The RBI is clearly taking a tentative approach. The rationale for this is that whilst credit derivatives have been lauded as "the most important [financial] instrument in decades[11]", they have been equally controversial (as discussed above), due to their perceived role in causing and exacerbating the global financial crisis of recent years.

Can India learn from the mistakes of others?

The RBI's 'softly-softly' approach is probably wise, in allowing market participants to use these products for largely hedging purposes, rather introducing complex, speculative, structured products from the outset. Coupled with this, market participants (and their legal and commercial advisers) have the benefit of seeing what has gone wrong globally, and have that rare opportunity to try and learn from mistakes of others.

What is clear from international jurisprudence is that the **negotiation and drafting of these contractual agreements is key**. Terms should be clearly defined. The courts' first port of call in all of the scenarios discussed above was to look at the plain language of the contracts. Parties entering into these contracts must ensure that they understand and anticipate both the potential negative and positive implications of entering into these contracts. While this is an exciting time in the derivatives market, it is also one that should be entered into with relative caution and thoughtfulness.

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[10] Fixed Income Money Markets and Derivatives Association of India. Note, globally ISDA provide the contractual documentation – it remains to be seen if there are any noticeable differences or areas of contention or uncertainty with regard to FIMMDA's contractual documentation.
[11] By Alan Greenspan, former Chairman of the US Federal Reserve.