CONSULTATION PAPER ON FLEXIBILITY IN PARTICIPATION BY MUTUAL FUNDS IN CREDIT DEFAULT SWAPS (CDS)

A. Objective

1. The objective of this consultation paper is to seek comments from the public on the proposal for allowing greater flexibility in participation by Mutual Funds in Credit Default Swaps.

B. Background

1. A Credit Default Swap (CDS) means a credit derivative contract in which one counterparty (protection seller) commits to pay to the other counterparty (protection buyer) in the case of a credit event with respect to a reference entity and in return, the protection buyer makes periodic payments (premium) to the protection seller until the maturity of the contract or the credit event, whichever is earlier.

2. Thus, buying a CDS is akin to buying insurance. In case any debt security on which a CDS is bought defaults, the protection seller (i.e, seller of CDS) pays the notional amount (amount of debt security) and takes over the debt security in default. The same is explained as under:

   Time 0: Entity A holds the debt security of Company X and buys a CDS from Entity P, to protect its position in Company X.

   Credit event: Company X defaults on its debt security, default being the credit event under CDS contract.

   Time 1: Entity A receives notional amount from Entity P and transfers debt security of company X to Entity P.

3. The Reserve Bank of India, on February 10, 2022, has specified the revised regulatory framework for CDS **"Master Direction – Reserve Bank of India (Credit**

Derivatives) Directions, 2022" to further develop the debt market in India. The guidelines seek to provide the necessary impetus for the development of CDS market by, *inter alia*, expanding the base of protection sellers including selling of protection by all major non-bank regulated entities including by Mutual Funds.

4. Under the current regulatory framework, Mutual Funds in India are permitted to participate in CDS transactions only as users i.e, to buy credit protection only to hedge the credit risk on corporate bonds held by them. Furthermore, the aforesaid transaction can be undertaken by Mutual Funds only in the portfolio of Fixed Maturity Plans (FMP) schemes having tenor of more than one year. In this consultation paper, comments are sought for proposal to allow participation of Mutual Funds in CDS buying (for all schemes), CDS selling (for all schemes except Overnight and Liquid) and the detailed framework in this regard.

5. In view of the revised RBI guidelines which now includes Mutual Funds under CDS sellers and based on detailed consultation with the stakeholders, comments are sought on the proposal to allow greater flexibility to Mutual Funds to both buy and sell CDS under a standard framework to ensure adequate risk management. The same shall serve as an additional investment product for Mutual Funds and also aid in increasing liquidity in the corporate bond market.

C. Consultation with stakeholders and Mutual Fund Advisory committee (MFAC)

1. Subsequent to issuance of revised guidelines by RBI in 2022, which *inter-alia* permits Mutual Funds to become protection sellers (seller of CDS contracts), a working group was set-up to suggest various measures with regard to participation of Mutual Funds in such instruments both as buyers and sellers of CDS. The proposal was also discussed in the Mutual Fund Advisory Committee ('MFAC').

D. Issue for public consultation

Based on the consultation with industry stakeholders and deliberations in MFAC, the proposed revised guidelines on participation of Mutual Funds in Credit Default Swaps are as follows:

1. Mutual Funds Schemes as buyer of CDS

1.1. MF Schemes may be permitted to buy CDS only to hedge their credit risk on debt securities they hold in all schemes. The exposure of CDS shall not exceed respective debt security exposure, and such exposure may not be added to gross exposure of the scheme.

Rationale: The buying of CDS may only be allowed for the purpose of hedge and any naked exposure may not be allowed as it leads to speculative position being held by Mutual Funds.

1.2. In case the protected debt security is sold, schemes shall ensure that the respective CDS position is closed within 7 days of selling the above protected debt security.

Rationale: The 7 days' time limit may be prescribed instead of a prior CDS square off condition to consider liquidity needs of scheme. Squaring off a CDS position may not be possible immediately as compared to selling the reference obligation (debt security). However, at the same time, the square off should be done within a short period of time, since it results in a speculative position being held by the scheme.

1.3. The exposure of any protected debt security, for determining single issuer, group and sectoral limits of MF schemes, may be considered as exposure to either issuer of debt security (reference entity) or seller of CDS, whichever has higher credit rating. The exposure shall form part of overall single issuer limits for the reference entity or seller of CDS, whichever is applicable. In case of same rating for reference

entity and seller of CDS, the exposure shall then be considered on reference entity and not on seller of CDS.

1.4. MF schemes shall buy CDS only from CDS programmes rated by Credit Rating Agencies.

Rationale: Since exposure of any protected debt security may be considered as exposure to either issuer of debt security or seller of CDS, whichever has higher credit rating, the rating of CDS seller should be available. Therefore, in order to enable purchase of CDS from sellers which are generally not rated (like Mutual Funds, Pension Funds etc.), or sellers with different ratings for different instruments, the rating of CDS programme would be appropriate. Also, the same would act as a risk management measure in terms of limiting excessive risks taken by the seller.

1.5. Schemes may buy CDS for both investment grade and below investment grade debt securities.

Rationale: Purchasing protection (CDS) for bonds that get downgraded subsequent to purchase by MF schemes and are thereafter rated below investment grade, would decrease the credit risk of such bonds held by MF schemes and hence, such transactions may be allowed.

1.6. Schemes may buy below investment grade debt securities protected by CDS.

Rationale: Since credit risk is protected/ transferred to seller of protection, the MF schemes may be permitted to purchase below investment grade bonds together with protection (CDS) purchased from above investment grade rated seller. In such cases, the exposure would be considered on seller of CDS as mentioned at para 1.5 above. The above is expected to increase available investment avenues for investment managers and also aid the liquidity in lower rated corporate bond markets.

Consultation No. 1

Whether the norms proposed in this section with respect to long CDS positions by MF schemes are appropriate? Further, whether the timeline of 7 days proposed for squaring off CDS position is suitable?

Consultation No. 2

Whether the rating of CDS programme should be mandated for buying of CDS by Mutual Funds?

Consultation No. 3

Whether mutual funds should be permitted to purchase below investment grade bonds along with protection (CDS) bought from investment grade issuer?

2. Mutual Fund Schemes as seller of CDS

2.1. MF Schemes may be permitted to sell CDS only as investors in synthetic debt securities, i.e., sell CDS on a reference obligation covered with Cash/G-Sec/T-bills. Overnight and Liquid schemes may not be permitted to sell CDS contracts.

Rationale: Selling of CDS with cover has similar credit risk as that of holding a debt security of the same issuer. Further, exposure is limited to notional amount, which is also similar to exposure value on a purchased debt security.

Thus, selling CDS is proposed to be allowed for Mutual Funds only as a buyer of synthetic debt security, i.e. Mutual Fund may buy a risk free security (like GSec/ T-bills/ Cash) and sell a CDS. Such a composite structure shall be similar to buying a debt security. The same is explained as under:

Time 0: Entity A holds G-Sec (equivalent to CDS notional amount) and sells CDS on Company X

Credit event: Company X defaults on its debt security, default being the credit event under CDS contract.

Time 1: Entity A pays the notional amount from the amount received from selling G-Sec and also receives defaulted debt security of Company X.

2.2. The following may be ensured with respect to the cover being kept:

2.2.1. Government securities with maturity within +/- 6 months the maturity of respective debt security (reference obligation) shall act as cover and such cover may be used for maintaining margin requirements on respective CDS.

It may be noted that open ended debt schemes except overnight and Gilt schemes are mandated to hold a certain percentage of their net assets in 'liquid assets' that *inter alia* include G-Sec, T-bills etc., in accordance with the framework for Liquidity Risk Management guidelines specified by AMFI. However, since the cover is earmarked to CDS sell position, investment in aforesaid instruments as cover shall not be considered liquid assets as part of Liquidity Ratio – Redemption at Risk (LR-RaR) and Liquidity Ratio - Conditional Redemption at Risk (LR-CRaR) eligible instruments.

2.2.2. The required amount of cover to be kept should be high enough to ensure that notional amount does not exceed the value of cover kept, hence the same shall be calculated as follows:

- Notional amount in CDS sell contract

  (+)
- Buffer, for price fluctuations on government securities kept as cover: The buffer shall be calculated to address interest rate risk on government securities. The buffer shall be atleast equal to 3 times the daily haircut applicable for the said G-sec instrument in case of CCIL transactions.

Rationale: As a prudent measure, the buffer is proposed to be kept at 3 times the daily haircut so as to account for multiple days of price fall in government securities due to interest rate change.

2.2.3. The value of cover kept shall be reviewed on daily basis.

2.2.4. The cover shall be earmarked to CDS sell position and may not be used for any other purpose till CDS sell position is open.

2.3. The exposure of synthetic debt security may be added to respective single issuer, group issuer and sectoral limits. Such exposure to the issuer, group and sector of the issuer shall be equal to the notional amount.

2.4. For the purpose of computing gross exposure of scheme investing in synthetic debt security, the exposure due to such investment may be computed as follows:

- Notional amount
  (+)
- Buffer (i.e., cover kept over and above notional amount)

2.5. Schemes may sell CDS only against investment grade debt securities.

2.6. Credit risk rating of the synthetic debt security shall be same as of reference obligation. For the purpose of Risk-o-meter, liquidity risk value of the synthetic debt security shall be

- Liquidity Risk Value of reference obligation + 2

Rationale: Considering there have not been many CDS transactions carried out in India, the CDS contracts are expected to be considerably less liquid. In order to reflect the same, the liquidity risk value may be increased by two, similar to a debt security having multiple special features in Risk-o-meter calculation.

2.7. For Potential Risk Class (PRC) matrix, Credit Risk Value shall be same as reference obligation.

2.8. **Debt Index funds and ETFs:** As part of norms for debt ETFs and Index funds, it is *inter alia* provided debt ETFs/Index funds shall be considered to be replicating the underlying debt Index subject to at least 80% of the NAV of the ETF/Index fund being represented by investment in securities forming part of the at least 60% of

weight in the Index and the securities of issuers not forming part of the index not exceeding 20% of the NAV at any point in time.

In respect of the current proposal, it is thus proposed that such schemes may also take exposure through synthetic debt securities and such investments shall be treated as replication as defined under the aforesaid referred norms.

Consultation No. 4

Should Mutual Fund schemes be permitted to sell protection i.e. short CDS as part of synthetic debt security?

Consultation No. 5

If Mutual Fund schemes are permitted to short CDS, whether the conditions provided in this Section are appropriate and sufficient?

3. Other conditions

3.1. Schemes shall comply with the directions issued by RBI from time to time in this regard.

3.2. Schemes shall participate in CDS only through standard contracts prescribed by Fixed Income Money Market and Derivatives Association of India (FIMMDA).

3.3. All CDS contracts shall be transacted either through Central Counterparty, if any or Request For Quote (RFQ) Platform.

3.4. MFs shall ensure Two-way Credit Support Annex (CSA) as part of CDS contracts.

Rationale: A CSA document sets out the terms with regard to provision of collateral in a derivatives contract. A one-way CSA requires one counterparty to post collateral, while a two-way CSA requires collateral from both sides. Two-way CSA further decreases the counter party risk (The risk that the protection seller is unable to pay, given the default on reference obligation), since margin is kept by both sides.

3.5. The disclosure of CDS transactions with associate or group companies of sponsor, if any, shall be made in periodic scheme portfolio disclosures.

3.6. CDS contract shall mature on or before winding up date of schemes.

3.7. Exposure through CDS (Notional amount of both CDS bought and sold) shall not exceed 10% of AUM of scheme and shall be within the overall limit of derivatives exposure prescribed in scheme information document.

Rationale: Considering there have not been many CDS transactions carried out in India, the CDS contracts are expected to be considerably less liquid, and therefore, to begin with, exposure to CDS is being capped.

3.8. **Valuation and Accounting:** AMFI in consultation with SEBI may issue detailed guidelines based on a waterfall approach that may be as follows:

- Level I: Actual Traded levels
- Level II: Corporate bond credit spreads

Consultation No. 6

Whether the two-way CSA should be mandated for CDS transactions by Mutual Funds? Alternatively, should the two-way CSA be mandated for issuer/ CDS programme rated AA and below?

Consultation No. 7

Whether the limit for exposure through CDS (Notional amount of both CDS bought and sold) appropriate?

Consultation No. 8

Any other suggestions regarding the overall proposed framework for participation by mutual funds in credit default swaps?

E. Public Comments on this Consultation Paper

1. Public comments are invited for the proposals as mentioned above. The comments/ suggestions should be submitted through the following link by **July 1, 2024**:

   https://www.sebi.gov.in/sebiweb/publiccommentv2/PublicCommentAction.do?doPublicComments=yes

2. In case of any technical issue in submitting your comments through web based public comments form, you may contact the following through email with a subject "Consultation Paper on flexibility in participation by mutual funds in credit default swaps (CDS)":
   a) Mr. Lakshaya Chawla, DGM (lakshayac@sebi.gov.in)
   b) Mr. Pranay Agrawal, AM (pranaya@sebi.gov.in)

Issued on: June 07, 2024

(End of Consultation Paper)