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The Reserve Bank of India

Submitted via email to
cgmidmd@rbi.org.in

Introduction of Credit Default Swaps (CDS) for Corporate Bonds

Singapore, October 4th, 2010

Dear Sirs,

We welcome the publication of the RBI's consultation on the *Introduction of Credit Default Swaps (CDS) for Corporate Bonds* in India and appreciate the opportunity to provide you with our views on this topic.

Markit is a financial information services company with over 2,000 employees in Asia Pacific, Europe, and North America. Over 100 of our employees are based at Markit India Private Ltd. in Noida which is a key operational, research and technology development hub for the company as well as our largest Asian office, and demonstrates our commitment to India and its financial markets. Globally, more than 1,500 institutions use our independent services to value financial instruments, manage risk, improve operational efficiency and meet regulatory requirements. We have a long track record of providing market participants and the public with price transparency on a wide range of financial instruments such as corporate bonds, CDS, and derivatives in other asset classes, with a focus on products that trade in the over-the-counter (OTC) markets. Today, all major market makers and buy-side institutions will use Markit's various pricing services to assist them in the process of price discovery and mark-to-market. Markit also owns and operates Markit BOAT, a platform that provides MiFID-compliant pre- and post-trade transparency for European equities.

Most relevant from the perspective of your consultation will be those services that Markit and MarkitSERV, a joint venture between Markit and DTCC, operate to allow the global CDS markets to function efficiently while reducing risk and increasing transparency. These services are pricing and valuation, electronic confirmation, the Reference Entity Database (RED), Credit Event auctions, as well as multilateral compression services.

We feel well positioned to comment on issues related to the development of an appropriate framework for a CDS market on corporate bonds in India and we hope that you will find our comments helpful.

Introduction

We believe that your consultation paper presents a framework for a CDS market in India that is both comprehensive and well thought through. However, we are of the opinion that you might want to take a number of additional aspects into account in order to ensure the success of such a market. These aspects are related to pricing and valuation, electronic confirmation, identifiers, Credit Event auctions, and multilateral compression.

1. Pricing, Valuation and Central Clearing

We appreciate the fact that your consultation paper highlights the role that Markit has played and continues to play in the development of transparent and robust pricing processes and models in the global CDS markets. We note your comment on the use of FIMMDA prices for G-sec valuations, and would strongly recommend the adoption of a similar process for CDS. Markit has extensive experience in the collection and cleansing of quotes from multiple contributors in order to generate reliable end-of-day prices, not only in our benchmark overnight pricing based on book-of-record contributions, but also through the creation of clearing prices for CDS that are used by several Central Counterparties (CCPs) in Europe and in North America. Based on our experience, we would be interested in working with FIMMDA to design a process which is both suitable for Indian markets and draws on the experience that has been gathered in international CDS markets.

We share your concern that illiquidity in the corporate bond market may adversely impact the CDS market. We believe that it would be helpful, either before or in tandem with the launch of the CDS market in India, to develop a comprehensive pricing service for corporate bonds, possibly along the lines of the existing FIMMDA G-sec service or modelled on existing Markit pricing services. We would expect such a service to be beneficial for the liquidity of the local corporate bond market and thus also to the nascent CDS market in India.

We share your view that a gradual approach to establishing central clearing is desirable as CCPs make most sense for products that have high volume, liquidity and price transparency. Without volume, the significant fixed costs of the CCP are likely to outweigh the potential benefits and place too onerous a financial burden on potential market makers. Without liquidity the CCP cannot assume that it will be easily able to replace the trades with a failing counterparty. Finally, without price transparency, the CCP will not have the reliable price history necessary to perform the risk analysis which is a pre-requisite to a credible margining policy.

As a result, the market will better develop if focus is initially applied to transparency, standardisation and risk management policy and practices for the market makers, rather than mandating the use of a CCP from the outset. This approach should be expected to create liquidity and volume, which might enable the creation of a CCP at a later stage. A well structured end-of-day pricing and valuation process and price dataset will facilitate an easy transition to a centrally cleared model. Based on our experience in the creation of daily CDS settlement prices for several CCPs in Europe and in North America we are open to working also with the authorities and local CCPs in India to assist them in this process.

2. Electronic Confirmation

No matter what financial product counterparties trade they should aim to document the details of the transaction in a timely and reliable fashion. Given the complexities of OTC derivatives as well as the size and number of these transactions, it is of utmost importance that the appropriate procedures and mechanisms for electronically confirming all legal details of these trades are established from the outset.

In the early days of the OTC derivative markets transactions were mostly confirmed on paper, via email, or through faxes. However, given the risks that non-confirmed OTC derivative transactions created, global regulatory authorities and the financial industry have worked hard over the last few years to establish electronic confirmation mechanisms for these markets. The timely electronic confirmation of CDS transactions is an essential tool to minimize legal risks, to enable regulatory oversight of the market, and to facilitate STP and central clearing. Electronic confirmation is most established for credit derivatives, where more than 99% of all eligible trades are electronically confirmed, compared to the more than 80% of interest rate derivatives and around 40% of equity derivatives[1] that are electronically confirmed.

[1] As for the G14 dealers, please see Markit Metrics for further details

We would like to emphasize that, in order to minimize the potential for error and reduce systemic risk, such electronic trade confirmations should not be limited to the basic economics of the transactions but need to include all of the trade parameters within a structured legal framework, e.g. master agreements that are based on industry-wide recognized documents provided by ISDA/FIMMDA or other recognized bodies. We therefore believe that the RBI should ensure that full electronic confirmation is both available and required for CDS transactions in India ahead of the creation of such market.

3. Identifiers

There have been numerous situations in the international CDS markets where inaccurate data related to the underlying reference entity and reference obligation on CDS trades has led to costly errors and market risk. Also, corporate actions often cause uncertainty about the correct "successor" entity on a CDS contract. Broadly, operational efficiency and automation demands the use of a unique and standard numbering system to identify reference entities and reference obligations.

The above issues drove CDS market participants to find a solution for a central and high-quality source of reference entity data. Over the course of many years, Markit has created and maintained the Reference Entity Database (RED), which now contains close to 10,000 active reference entities, of which more than 3,000 have been legally verified. Within RED, there are 143 current entities incorporated in India. All RED reference entities and obligations are identified using RED 6-digit and 9-digit codes, which are widely used by market participants.

We believe that the creation of a database that provides robustly-validated reference entity and reference obligation information coupled with a widely recognized identifier is essential to reduce the potential for errors and ensure operational efficiency in any CDS market. We would be open to working with the RBI and industry participants to identify, scrub and verify those additional entities that are expected to trade within the Indian CDS market.

4. Credit Event Auctions

To ensure the effective functioning of a CDS market it is essential to appropriately define the mechanics of how these transactions are settled after the occurrence of a Credit Event. One could even argue that without the establishment of a transparent and credible Credit Event settlement mechanism, any envisaged CDS market is likely to fail.

Over recent years ISDA, in cooperation with market participants, has designed and implemented a global procedure to determine the value of outstanding CDS post Credit Events in an efficient fashion. Markit operates as an administrator in this process. To determine the market clearing price for Deliverable Obligations, Markit, together with its co-administrator Creditex, collect bids and offers for the relevant instruments from market participants via the various market makers, then runs an algorithm to match orders and determine a final price using a two-round auction process. At each step the relevant information is disseminated simultaneously to the market makers and to the public in order to ensure transparency. This auction process was first used in 2005 and, to date, has been successfully performed to settle over 90 events with an open interest of USD 19bn in Europe, North America and Asia, including some of the largest Credit Events in history such as Lehman, Fannie Mae and Freddie Mac. The auction mechanism has established itself as a cornerstone of the global credit derivatives markets and has been positively reviewed by both regulators and market participants.

Based on our experience, we believe that the use of a credible auction mechanism to be operated post Credit Events is essential to ensure a well functioning CDS market in India. It should be similar to the one that has been established and tested globally.

5. Trade Compression

In an active OTC derivative market where transactions are not centrally cleared and counterparties manage their exposure on a portfolio basis, there is a tendency for the gross notional and the number of outstanding contracts to grow significantly over time, even if the actual net exposures might be small. This can result in the emergence of systemic as well as operational risk which is not desirable from the perspective of regulators and market participants. Trade compression can address this issue by removing economically redundant trades and reducing the outstanding gross notional amounts to a level which is closer to the actual net exposures.

In the early days of the OTC derivatives markets compression activities were only performed occasionally and on a bilateral basis. However, over the past several years, regulatory attention helped to drive the use of multilateral compression to substantially reduce outstanding trades in the global OTC derivatives markets. Whilst there are a number of service providers that have worked with the industry to enable compression across the different asset classes and product variations, Markit has performed most of the multilateral compression for single name CDS globally. Over the last two years, Markit and Creditex together have worked successfully with market participants to remove more than 830,000 single name CDS transactions with a total notional value of more than USD 6.5 trillion.

As regular, multilateral compression cycles provide an important systemic and operational risk management tool in any CDS market, they should also be part of the design of the Indian CDS market from the outset. The frequency and scope of such compression should be a function of the number of market participants, the number of active reference entities and the trade frequency.

We hope that are comments are useful for you. Please do not hesitate to contact us if you require any additional information or if you want to discuss.

Kind regards

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