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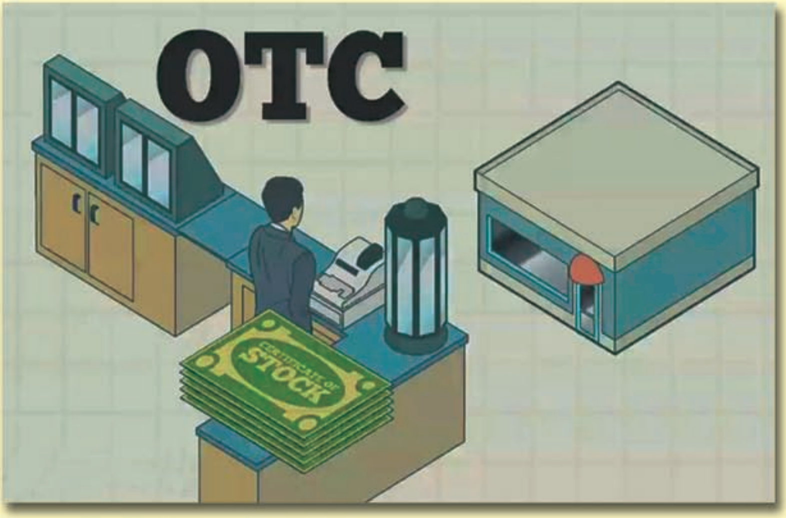

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Theme 279

OVER-THE-COUNTER (OTC) DERIVATIVES MARKET REFORMS

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Theme No: 279 : Over-the-Counter (OTC) Derivatives Market Reforms

A well informed customer will make the policy makers as well as organisations which produce goods and services more responsive to the customer needs. This will also result in healthy competition among organisations and improve the quality of goods and services produced.

The "SIB Students' Economic Forum" is designed to kindle interest in economic affairs in the minds of our younger generation. We highlight one theme in every monthly meeting of the "Forum". The OTC derivatives, permitted to be traded in India, are Interest Rate Swaps (IRS), Forward Rate Agreements (FRA), Forex Forwards, Currency Options & Swaps and Credit Default Swaps (CDS). An Implementation Group on OTC derivatives Market Reforms has been constituted with representatives from RBI and market participants headed by Shri R. Gandhi, Deputy Governor (then Executive Director), RBI.

What is a derivative?

A derivative is a financial instrument whose price is dependent upon or derived from one or more underlying assets. The derivative itself is merely a contract between two or more parties. Its value is determined by fluctuations in the underlying asset. The most common underlying assets include stocks, bonds, commodities, currencies, interest rates and market indexes. Derivatives are generally used as an instrument to hedge risk, but can also be used for speculative purposes. Futures, forwards, options and swaps are examples of derivatives.

How are derivatives traded?

There are two distinct types of derivatives; each is traded in its own way. Exchange-traded derivatives are traded through a central exchange with publicly visible prices. Over-the-counter (OTC) derivatives are traded and negotiated between two parties without going through an exchange or other intermediaries. The market for OTC derivatives is significantly larger than for exchange-traded derivatives and was largely unregulated until the Dodd-Frank Wall Street Reform and Consumer Protection Act prescribed new measures to regulate derivatives trading. The OTC market is composed of banks and other sophisticated market participants like hedge funds, and because there is no central exchange, traders are exposed to more counterparty risk.

What do you know about the Indian derivatives market?

In India, the OTC derivative products were introduced in a phased manner keeping in view the hedging needs of the real sector. The small size of the OTC derivatives market, low level of complexity in products and robust regulation resulted in orderly derivatives market development and reduced the concerns with regard to systemic risk.

What is the roadmap for implementation of reforms in the derivatives market?

The pace and nature of reforms in the derivatives market depends on the domestic market conditions. The rapid growth in OTC derivatives markets necessitates increased awareness of the systemic importance of these markets and potential risks inherent in market practices. The weakness of the OTC derivative markets was exposed in 2008 financial crisis with limited transparency, build up of systemic risks and potential for contagion. In response to the financial crisis, the G-20 initiated a series of reforms designed to strengthen the regulation and oversight of the financial system and the Financial Stability Board (FSB) is coordinating the reforms and assessing their implementation

What are the major recommendations of the G-20 summit?

- *Standardization*: CDS transactions are standardized in terms of documentation, coupon, coupon payment date etc. IRS contracts are to be standardised to facilitate centralized clearing and settlement. IRS on Overnight Index Swap for interbank trades has been standardized from April 1, 2013 other benchmarks in IRS would be standardized in a phased manner

- *Central clearing*: More than 90% of IRS trades are currently being centrally cleared on a non-guaranteed basis without regulatory mandate. There is a guaranteed centralized clearing arrangement for settlement of USD-INR forwards though central clearing is not mandated by regulation. CDS market is still developing and it may take more time to achieve the necessary market activity to support central clearing of CDS transactions.

- *Exchange or electronic platform trading*: Electronic platforms are available for transactions involving forward rate agreements and foreign exchange swaps. Forex forwards can be traded on FX-SWAP trading platform. Gandhi Committee has also recommended introduction of an electronic swap execution facility (electronic trading platform) for the IRS market.

- *Reporting to trade repositories*: RBI had already put in place a reporting arrangement for interbank/PD transactions in Rupee Interest Rate Swap (IRS)/ Forward Rate Agreement (FRA) in August 2007 itself. The CCIL's reporting platform for OTC foreign exchange derivatives was introduced on July 9, 2012 and was expanded thereafter in three phases to cater to the reporting of interbank and client transactions (threshold of USD 1 million and equivalent in other currencies) in various actively used derivative instruments. The last phase was rolled out on December 30, 2013, in which reporting of client transactions in Rupee IRS/FRA was also covered. The reporting platform for Credit Default Swaps (CDS) was put in place from the date of introduction of the instrument itself, i.e., December 1, 2011.

What is central clearing?

Central clearing is the process in which financial transactions are cleared by a single (central) counterparty to reduce individual risk. Each party in the transaction enters into a contract with the central counterparty, so each party does not take on the risk of the other defaulting in this way, the counterparty is essentially involved in two mutually opposing contracts.

What do you mean by a trade repository?

A trade repository is a centralised registry that maintains an electronic database of records of transactions. Use of trade repositories would improve operational efficiencies in post-trade processing, either by the trade repository or by other service providers that use the data maintained by the trade repository. Data from a trade repository can be used to facilitate electronic trade matching and confirmation, settlement of payment obligations, trade affirmation, portfolio compression and reconciliation, and collateral management thereby resulting in risk reduction and improved operational efficiencies for individual market participants.

What are the recommendations for central clearing?

IRS: Though it is not mandatory for banks to clear interbank trades through CCIL's non-guaranteed central clearing, more than 90% of trades are being centrally cleared.

Forex Forward and Forex Swaps: Guaranteed central clearing facility is being provided by CCIL in forex forward. Though RBI has not mandated banks to clear their trades through the CCIL's CCP based clearing, currently around 30% of trades are being cleared under guaranteed settlement mechanism. As regards swaps, guaranteed central clearing facility is being provided by CCIL separately for the two legs of the swap. Keeping in view the benefits of CCP based clearing.

Forex Options: CCP clearing for forex options may be reviewed by March 2015 subject to improvement in liquidity.

Currency Swaps, IRS in Foreign Currency(FCY), Interest Rate Option in FCY: it is recommended that a review may be done in 2015.

CDS: it is recommended that CCP based clearing for CDS contracts may be put in place by March 2015.

How does the working group present the electronic *trading platform?*

It is recommended that the electronic trading platform may to be put in place by

September 2014 subject to approval from RBI. In the case of *Forex Forward,* there is no exclusive trading platform available at present. However, forward trades can be traded in CCIL's FX-SWAP trading platform for certain maturities. As such, it is recommended to introduce an exclusive trading platform for forex forwards, subject to standardisation and trades attaining a critical mass. Presently trading platform developed by CCIL and Reuters are available for trading in forex swaps. However, there is no regulatory requirement to mandatorily execute trades on any of these trading platforms. Forex Option is not very standardised to be traded on an electronic trading platform. It has been recommended to put in place a trading platform after a review by March 2015. Market liquidity is not sufficient to consider setting up trading platform for *Currency Swaps, IRS in FCY, Interest Rate Option in FCY*. There is no trading activity in CDS also.

What is the margin requirement prescribed?

It is recommended that non-centrally cleared IRS trades (including client trades) should be subject to margin requirements where as for physically settled forex forwards and swaps, initial margin requirement may be exempted. RBI has already prescribed margin for CDS.

What are the constraints in the implementation of reforms?

India is committed to adopting OTC derivatives reforms. In India, the OTC derivatives are simple products with low volumes. Also there are issues like market liquidity, valuation norms, participant's sophistication in trading strategies, use of product as hedge etc. which impact scope for standardisation and the adoption of central clearing for roll-out of reforms The Working Group is aware of these factors and accordingly recommended the roadmap with milestones dependent on exogenous variables like improvement in liquidity.

Current Status: OTC Derivatives:

Product/G-20 requirements		Trade Repository (for both interbank and client trades)	Standardisation	Central Clearing (CCP)	Electronic trading platform	Higher capital / Margin requirements for non-centrally clearing OTC derivative trades
Interest Rate Derivatives	IRS	Available for both interbank and client trade	Partial- MIBOR standardised.	Non-guaranteed central clearing in place. CCP based clearing under consideration.	Not available. Electronic trading platform consideration.	No margin requirement
Credit Derivative	CDS	Available for both interbank and client trades.	Standardised.	Not available.	Not available	Margin requirement in place
Forex OTC Derivatives	Forex forward	Available for both interbank and client trades (FCY -INR & FCY-FCY).	Not available as majority of interbank trades driven by customized client trades.	Guaranteed Central clearing available. RBI has not mandated it.	No exclusive platform available. Can be traded on FX- SWAP.	No regulatory requirement.
	Forex Swap	Available for both interbank and client trades (FCY -INR & FCY-FCY).	Not available as majority of interbank trades driven by customized client trades.	Guaranteed Central clearing available. RBI has not mandated it.	Can be traded on CCIL and Reuters' trading platform. Majority of trades done through brokers.	No regulatory requirement.
	Forex option	Available for both interbank and client trades (FCY -INR & FCY -FCY).	Not available as majority of interbank trades driven by customized client trades.	Central clearing not available.	Not available.	No regulatory requirement.
	Currency Swap	Available for both interbank and client trades (FCY -INR & FCY -FCY).	Not available.	Not available.	Not available.	No regulatory requirement.
	IRS in FCY	Available for both interbank and client trades.	Not available.	Not available.	Not available.	No regulatory requirement.
	IRS option in FCY	Not available due to negligible trading volume.	Not available.	Not available.	Not available.	No regulatory requirement.

Your comments and feedback on this publication may be sent to Staff Training College, The South Indian Bank Ltd., Thrissur 680 001 or by E.mail: ho2099@sib.co.in

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