MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

October 2, 2010

Via Electronic Mail: cgmidmd@rbi.org.in

Alpana Killawala
Chief General Manager
Internal Debt Management Department
Reserve Bank of India
Central Office Building, 23rd floor
S.B. Road, Mumbai-400001

Re: Draft Report of the Internal Group on Introduction of Credit Default Swaps for Corporate Bonds

Dear Ms. Killawala:

Managed Funds Association ("MFA")[1] appreciates the opportunity to comment on the Reserve Bank of India's (the "Reserve Bank") Draft Report of the Internal Group on Introduction of Credit Default Swaps ("CDS") for Corporate Bonds dated July 2010 ("Draft Report").[2] MFA appreciates the Reserve Bank's willingness to consider varying market perspectives on the Draft Report and applauds its efforts to finalize the operational framework for the introduction of CDS for corporate bonds.

MFA members are active participants in over-the-counter ("OTC") derivatives markets around the world and have a strong interest in promoting the integrity and proper functioning of those markets. As the Draft Report recognizes, "[e]ffective management of credit risk has become increasingly critical for banks' and other financial institutions' risk management strategy to ensure that their financial health remains sound."[3] However, we are concerned that the Draft Report introduces a framework that will be of limited benefit to banks, financial institutions,

---

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

[2] Available at: http://www.rbi.org.in/scripts/PublicationDraftReports.aspx?ID=592.

[3] Draft Report at 4.

In addition, OTC derivatives markets also provide significant benefits to the global economy by providing liquidity for capital markets. For instance, banks and other financial institutions have been able to engage in increased lending and corporate finance activities as a result of their ability to trade CDS, which provides them with a mechanism through which they can transfer credit risks to other market participants, which are willing to accept that risk. Ultimately, increased lending and credit flows result in: (i) lowered costs of borrowing for many big and small businesses all around the world; and (ii) greater access for consumers to credit to purchase necessary goods and services.

corporations, other entities, and ultimately to the real economy[4] because it restricts the use of CDS to "users" (as such term is defined in Section 2.2.2 of the Draft Report) with an underlying exposure to the relevant corporate bond. We believe our knowledge and experience of the global CDS markets may prove helpful and we respectfully submit comments in this respect.

I. CDS Markets

Like the markets for other products, to have properly functioning CDS markets, there need to be both buyers and sellers. Market prices are the end result of the competing views of market participants. As a result, prohibiting users "from buying CDS unless they hold underlying cash market positions" (*i.e.*, prohibiting "naked" CDS or CDS without exposure to the underlying") and from selling CDS entirely would create an unbalanced market with more buyers then sellers. Such a prohibition would limit the number of market participants available to sell credit protection to hedgers. As the Draft Report acknowledges, permitting CDS without having an underlying is important for market liquidity, price discovery, proxy hedges and lowering the cost of hedging.[5]

Generally, when a hedger buys credit protection, it purchases protection from a dealer or market maker. At execution, the market value of the CDS to each side of the trade is zero. This is because the price of the swap will be based upon the credit spread at execution. One party will be long on the trade (benefiting if the spread goes up), and the other will be short on the trade (benefiting if the spread goes down). After execution, that spread will move, up or down, which will create value to one of the parties. Swap dealers net their positions by offsetting their long positions with short positions; and offsetting their short positions with long positions. This is often called running a "matched book". In reality, this process is not so simple. The face value of each trade, known as the notional amount, is not likely to match up perfectly with the other trades. So, a dealer looks to other market participants, such as other dealers and hedge funds, to help it net its positions acquired by selling protection to its clients. Similarly, a hedge fund selling protection to a dealer, then buys its own credit protection to offset its risk (*e.g.*, buying CDS on a comparable company in the same sector), which creates a cycle where each market participant separately buys and sells protection to mitigate its risk and the risk to the system.

By prohibiting CDS without an underlying, the Reserve Bank would make it very difficult for market makers to offer protection to their clients in CDS as they would be unable to run a matched book due to the inability of other users to sell CDS. As such, the ability of market participants to mitigate credit risk through the use of CDS would be reduced.[6] Moreover, prohibiting CDS without an underlying could potentially create greater systemic risk by concentrating risk in market makers.

In addition, restricting use of CDS without exposure to an underlying cash market position would limit the ability of market participants to use CDS to hedge broader types of financial risk, such as exposure to loans and other business agreements. For example, an

---

[4] *See* discussion at note 6, *infra*.

[5] Draft Report at 17.

[6] As the Reserve Bank is aware, the limitation on market participants to hedge or mitigate credit risk has direct implications for the real economy. Banks are able to extend less credit to companies, and in turn, companies then have less cash to reinvest in or expand their business, or to use to hire employees.

automobile company may have a contract with a company to supply it automobile parts, and hedge its financial exposure to the risk of the supplier failing to deliver parts and going bankrupt through CDS protection. In the U.S. and Europe, businesses, financial institutions and investors have found OTC derivatives to play an important role in isolating, transferring and managing various forms of risk according to their own needs and specifications.

Finally, CDS are not substantively different from derivatives used to either hedge or take risk in other asset classes (*e.g.*, equities, interest rates, foreign exchange, commodities). For example, purchasing CDS protection can be compared to purchasing a put option on an equity of the same issuer where the premium paid on the CDS is analogous to the premium paid to purchase the option. A holder of either derivative will profit from a deterioration in the underlying issuer's business. Accordingly, a requirement to own the underlying would result in the trading of, and investing in, credit risk being differentiated from all other asset classes. We are not aware of any similar requirements for holders of put options to own the underlying assets.[7]

II. Responses to Concerns of the Draft Report

The Draft Report raises concerns against permitting CDS without having an underlying, such as excessive leverage and systematic risk, perverse incentives and destabilizing cash markets.[8] We believe the solution is for the regulatory framework to address the specific concerns relating to CDS, rather than wholesale prohibiting CDS without an underlying.

With respect to the Draft Report's first concern, we believe excessive leverage and systematic risk can be managed through collateral and margin requirements. As the Reserve bank is aware, capital requirements for dealers, banks and other depository derivatives counterparties protect customers from excess risk-taking by such financial entities, and protect such entities' customers and counterparties from the risk of loss in the event of such dealer, bank or depository institution's failure. In the absence of capital requirements for such financial entities, they would have the ability to leverage their customers' assets without limitation and on an unsecured basis. Non-dealer, OTC derivatives counterparties such as MFA's members, on the other hand, are generally required (by dealer counterparties) to post collateral with their dealer counterparties at levels that reflect the risks of each member's failure.[9] As such, non-dealer, OTC derivatives counterparties are intrinsically limited in the amount of leverage they may use because they do not typically have access to unsecured financing.[10] The Draft Report also raises the concern, with respect to systemic risk, that the amount of protection purchased could be higher than the total number of bonds outstanding. We do not believe this is a systemic risk issue, but rather an issue

---

[7] Of course, not all participants in the CDS markets seek to hedge their positions. CDS markets, like other financial markets, permit those who seek to avoid risk to transfer that exposure to those who are willing to accept risk in exchange for the opportunity to profit, *i.e.*, speculators. The participation of speculators is essential to the operation of any market that affords liquidity and price transparency.

[8] Draft Report at 18.

[9] New U.S. legislation, the Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted on July 21, 2010, requires regulators to impose collateral and margin requirements with respect to OTC derivatives.

[10] For example, according to a recent study by academics at Columbia University, the leverage ratio of investment banks during the period from December 2004 to October 2009 was 14.2, with a peak of 40.7 for in 2009, and the leverage ratio of the entire financial sector during that period was 9.4. Hedge Fund Leverage, available at: http://www2.gsb.columbia.edu/faculty/aang/papers/HFleverage.pdf.

of whether parties can meet their settlement obligations. We believe that allowing users the option of cash, auction or physical settlement promotes an orderly settlement and that the ISDA Big Bang and Small Bang protocols[11] have proven successful in streamlining CDS trading and settlement procedures.

With respect to the notion that CDS may have an effect on the destabilization of cash markets, we believe that prohibiting CDS without an underlying is more likely to distort market prices by creating markets with more buyers than sellers. By eliminating a natural group of CDS sellers from the market, the CDS price will likely be higher than would be expected if it only reflected the market's expectation for the prospects of the reference company, *i.e.*, there will be a liquidity premium embedded into each price that will make the cost of hedging more expensive and possibly prohibitive. We believe that the prohibition on CDS without an underlying has the potential to eliminate the benefits of CDS entirely by making it too costly for market participants to transact.

The Draft Report states that "unregulated financial products entail significant negative externalities".[12] We believe a regulatory framework with appropriate rules regarding CDS can address many of the Reserve Bank's concerns and that regulatory oversight rather than a prohibition would be a more pragmatic approach.

* * * * *

MFA appreciates the opportunity to comment on the Draft Report. MFA supports the Reserve Bank's efforts to create more efficient OTC derivatives markets, reduce risks and protect the stability of the global financial system. Please feel free to contact Jennifer Han or the undersigned if you have questions or would like to discuss the foregoing.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President & Managing Director,
General Counsel

[11] Draft Report at 8.

[12] Draft Report at 19.