

# A Glimpse of Indian Financial Sector Risk Management Framework

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## ABSTRACT

The latest Credit Derivatives Determination Committee 2021, established by the top bank Reserve Bank of India (RBI), outlines the way forward for the credit derivatives market. Indian derivatives are equities, bonds, commodities and currencies. The Bombay, the National Stock Exchange and the Multi Commodity Exchange are accessible. However, the banks' market for credit derivatives or securitisation is mostly absent. This is one of the most important components of the developed economy worldwide. The primary feature of the credit derivative is that it transfers the risk of the originator to investors who are ready to accept the risks and be exposed to the market to diversify their investments. One benefit of bank credit derivatives is that it lowers deposit dependence as capital and makes banks more accountable to manage their risk exposure. Not to add accountability and transparency, because they are evaluated by credit rating agencies, when it issued the credit derivatives. Credit derivatives are designed to transfer risk, call risk, and credit risk. The purpose of this study is to analyse the possibilities and difficulties of the market in credit derivatives in India, particularly for banks that are undercapitalized and have significant problems with their repayment. How this would also alter the whole market from an investment perspective. This article also presents the idea of credit derivatives and its many histories and aspects at their inception. The article is conceptual in nature and serves to establish a path ahead for future study when the market peaks. However, RBI issued the previous circular in 2011 under the heading of "Revised Credit Default Swap (CDS) Guidelines for Corporate Bonds," which did not fully explore the market's potential. Almost ten years later, the current circular on the creation of the committee of 2021 looks forward to its recovery and reduces the dependence of the banks on its traditional sources of funding. Only time will tell how far it was accomplished in the Indian banking industry with so many difficulties.

## Keywords

Credit Derivatives, Credit Default Swap, OTC, Portfolio, RBI.

## INTRODUCTION

The financial instruments designed to shift the credit risk of one asset from one party to another are credit derivatives (CD). This is established by the asset management to acquire or reduce the exposure to credit risk. In addition, different asset managers' portfolios are susceptible to market rate fluctuations, wherein credit derivatives are an effective method to control risk exposure. The fund managers target particular loan exposures

via credit derivatives to improve their portfolio returns. This enables asset managers to get exposed to another investment segment, which would not otherwise have been accessible. This helps to increase and improve performance via more diversified investment options[1].

RBI Direction 2021 has recently been launched by the Reserve Bank of India (RBI) with the aim of creating the Credit Default Swap (CDS) market as a fundamental component of increasing corporate liquidity. The proposed rules will apply to the transactions on recognised stock exchanges and over-the-counter (OTC) marketplaces for credit derivatives. To comprehend the CDS market, we need to understand the different credit derivative offers available. CD is not just limited to CDS, since there are numerous financial products under its scope. Derivatives include asset swaps, credit default swaps, full returns, credit links, forward distribution of credit and credit dispersion options. Banks support the second kind of CD with regard to index solutions that connect the payment with a specific market lending exposure. The most common type of CD is considered CDS, which also comprises single-name credit default swaps and basket default swaps. It has been noted in recent times that banks need a method to reduce credit risk without expanding their balance sheet load and that financial derivatives may provide a possible answer[2].

The financial crisis in the United States, 2008, had a worldwide impact and credit derivatives, particularly the CDOs, which had many other credit derivatives instruments as a hotspot for this catastrophe. But it remains one of the key instruments for banks to reduce credit risk exposure and is recognised globally with openness and accountability for its potential uses. It is conceptual in character and factual and aims at comprehending the usage of credit derivatives within the Indian financial system and how the dent may be transformed in the country's existing banking sector.

## 1.1 Related Studies

Derivatives may be linked to an ancient civilization like Mesopotamia, in which the King made orders about farmers' borrowed money. The nature of the regulation was such that, if the rains were insufficient, harvests would drop and lenders would have to forget the farmers' loan (a classic example of put option). Another example may be traced back to the civilization of Greece, when a disciple of Aristotle prophesied that the olive output will rise suddenly the next year. This prompted him to buy all the olive fields before the harvest season and his forecast of high olive output, which led to great profit, was actually high. This is an example of an advance contract. Around the 19th

century, America was a centre of financial innovation and the Chicago Board of Trade (1848) was set up by the farmers to protect against purchasers for goods. This has developed into the first market for derivatives. In India, derivatives markets may be traced back to 1875 when the Bombay Cotton Trade Association was formed. In 1952, the Government of India placed a prohibition on cash settlement and trading options confined to the informal forward market [3].

Credit derivatives are part of the derivatives market, as previously stated, transactions that facilitate the transfer of credit risk from one financial market player to another. Credit derivatives innovation took occurred in the 1990s as a way for banks to hedge and diversify credit risk in order to improve their performance. It also gives financial firms a cheap option to address exposure to credit risk. It has therefore become more commercially secure than others from an illiquid asset (risk). To comprehend credit derivatives, we first need to understand credit risk, as it is at the heart of the development of the financial hedging instruments. Credit hazards include downgrade risk, default risk and credit risk. What are the risk default? These were the dangers associated with any tentative default by the debtor on an outstanding loan or bond issuer. These may be in whole or in part the remaining sum. What are the risk of downgrade? It is essentially a risk type when a credit rating agency recognised lowers the existing credit rating on the basis of the issuer's profitability, along with the ability to fulfil its debt obligations. Finally, what are the dangers of credit spread? These are the risks associated with the growing distribution of outstanding debt above the reference rate. In addition, the pay-offs rely heavily on the occurrence of credit events[4].

The International Swaps and derivatives Association (ISDA) identifies 8 credit events, i.e. credit event after merger, cross-acceleration, failure to pay or reorganise bankruptcy, cross-default, repudiation, or moratorium. On the basis of these credit events, eight key financial-market credit derivatives may be identified as:

- Credit defaults swaps;
- Index swaps like credit default index swaps;
- Basket default swaps;
- Asset swaps,
- Total return swaps,
- Portfolio and
- Credit-linked notes.

Credit derivatives are also seen in index products which, along with investor payoffs, are sponsored by banks tied to a particular credit risk. There are two kinds of credit-default swaps, i.e. one name credit-default swap (with only one reference-based asset) and basket-default swap (with just one reference-based asset) (with multiple reference assets). Credit derivatives are further split into two categories: financed instruments and non-funded instruments. A funded CD happens if the security seller (i.e. the financial) pays the security buyer an advance payment, while this aspect is absent in the unfunded credit derivatives. In contrast with other derivative instruments sold both on the exchange and via OTC or dealer arrangements, the credit derivatives are also the only OTC products. This makes individual financial transactions negotiable and cannot take the shape of futures, options, swaps or forward[5].

Protection purchasers are the companies interested in safeguarding the credit risk. Protection sellers are those organisations who are mostly interested in diversifying their portfolios via alternative credit derivative investing.

Intermediaries are the firms that offer liquidity to end customers, such as investment banks or commercial banks or securities companies. The middlemen concentrate on arbitration and other possibilities to maximise their profit margin. The transaction comprises of a benchmark entity (a benchmark issuer) and a benchmark obligation where the former refers to the issuer and the latter to the reference property to which protection is being sought[6].

One of the main concerns for banks, bond issuers and bond investors was credit risk. Traditional risk management techniques such as securitisation, diversification by means of bank loans sometimes provide a partial answer to the issue. On the other hand, the credit derivative market has expanded the alternative by offering different new instruments to manage credit risk. Credit derivatives are used by loans such as commercial banks and mutual funds to prevent bad results. The greatest difficulty in its development is the agreement with regulators on their legality and internal procedures. According to a 1988 study by the British Bankers Association, researchers reported various kinds of derivatives on the market Credit default swaps stood for 40%, total return swaps represented 10%, credit spread instruments accounted for 23%, credit linked bank notes accounted for 16%, and other assets accounted for about 11%. The survey also highlighted a few popular observations regarding the use of credit derivatives, where the banks considered the following areas important: credit line management, diversification and economic capital management, investment, regulation capital management, balance sheet optimization and product structuring. The market likewise increased yearly over 200% about 2000[7].

Credit derivatives may be seen as a symbiotic connection between the credit derivatives market, the bond market and the reportable market in developing countries. The primary players in the credit derivatives market were the leading players in the bond market. In the case of credit crises in countries like Russia, Ecuador and Argentina, the credit default swaps have been considered an essential financial tool. In examining the optimal bank behaviour against a dangerous financial market credit portfolio and the usage of credit derivatives to cover the risk, a complete hedge was determined to be the best choice if derivatives markets are neutral. An alternate research was performed to see whether the destabilising effect of credit derivatives on the banking industry has had a detrimental influence. Credit derivatives were found to enhance bank risk, especially when there are significant credit sectors.

This presents a challenge for regulatory authorities, because the aggressive use of credit derivatives has increased economic success and reduced the potential to undermine banking stability. It has been found that banks buy credit derivatives when larger term borrowers are more concentrated when credit availability increases. This shows that the benefit of credit derivatives is undone and the effect of this may be observed in the increased volume of loans and duration of loans. When the credit risk was decreased through CDS and other OTC derivatives, the counterparty risk has been shown to remain a significant issue. The high liquidity characteristic of credit derivatives is also a concern, which may be further synthesised and loses its integrity. It can only succeed if there are regularity authorities' risk management checks that are virtually difficult[8].

The 2008 financial crisis has shown the dark side of derivatives challenging the bubble monitoring involvement of regulatory agencies. In 2010, the Dodd-Frank Wall Street Regulation and

Consumer Protection Act were launched as a means of regulating over-the-counter derivatives (OTCs) after the financial crisis. The Act has two key provisions: firstly, that OTC derivatives shall be exchanged on trade and, secondly, that a central clearing be established. The CDS market also has a detrimental impact on the secondary bond market because of trade shifts towards the former where there are fewer relative pricing mistakes and reduced liquidity on the bond market. In recent years, credit derivatives have gained appeal as a way of hedging risk, but they do not seem to be resolving the key issue of risk management at source or at point of origin. Therefore, credit derivatives should be avoided as a panacea for the management of credit risk. Previous research has shown that major variables affecting credit derivatives include size, distress costs, impact of other derivative products, capital position and credit risk levels. In addition, banks that purchase credit protection in the end will profit more[9].

## 1.2 RBI Credit Derivatives Working Group

In 2003, the RBI established a working group to explore credit derivatives possibilities in India. The committee discussed the matter and produced a three-segment study focusing on the theoretical framework, necessities and opportunities in India and the regulatory issues. As stated in the literature study, the conceptual foundation stays almost similar. Therefore, the necessity and scope of credit derivatives is taken into account in this sector. The working group emphasised the usage and advantages of the credit device:

- The interest rate derivative product was a successful product launched in the recent past, where the number of market participants has grown. This enabled a participant to safeguard the interest rate risk from one participant to another, particularly from risk-averse to market participants.
- The market for credit derivatives also offers a cost-effective and efficient method for the transfer of risk between participants. The luminosity of the credit risk of the financial institutions and the limitation of access to the credit market by insurance companies, mutual funds and so on may reflect the current market arrangements.
- The credit-derivation mechanism will offer the current alternatives with a long-term solution to protect financial institutions from risk.
- The system will also enable the creation of tranches based on the risk profile and the time horizon (tenure) of interested investors, such as a mutual fund industry.
- Credit derivatives market will also provide a comprehensive advantage for all players, as banks may use their capital effectively and manage their destination risk portfolio flexibly.
- Risk diversification will contribute to financial stability and other players, as the banks are free to build and manage the credit risk portfolio.
- Credit derivatives are more liquid than insurance, guarantee and securitisation.
- Credit insurance provides credit insurance to insurance firms, which have limited banks' involvement in this respect, but credit derivatives expand this to other petrification banks as protection vendor.

- Credit derivatives may also cover the risk of sovereign funds.
- Insurance firms and agencies with mutual funds are limited to direct credit exposures, such as lending etc., accessible through credit derivatives otherwise not available to them.

Since credit risk is transferred through credit derivatives, credit spreads are reduced as reference assets are no longer illiquid. An additional important observation made by the Working Party was the need to increase the number of financial institutions, banks, NBFCs (Non-Banking Financial Corporations), insurance companies, mutual funds and other corporate entities, in order to sustain an effective functioning of the credit market.

## 1.3 Directions for Draft Guidelines

The next part relates to some of the main findings of the proposed rules which aim to permit OTC derivatives across India's authorised stock exchanges. In order to take part in the above stated market, the Regulations must set forth rules on residence and non-residency in Indian. Single name, credit default swaps and highly banned synthetic CDS products or structured financial instruments would be allowed on the market. All of the relevant reference entities and CDS liabilities must be listed and unlisted INR corporate bonds and non-listed INR bonds authorised for special purpose vehicles (SPVs) formed by infrastructure firms. Also eligible reference entities are certificates of deposit, advertising papers and non-compatible preferred stocks with current maturity up to one year. As reference duties, only dematerialized reference obligations will be recognised. In addition, both Asset-Backed Securities (ABS) and Mortgage-Backed Securities (MBS) terminology were explicitly defined. Credit or guaranteed, convertible bonds, including call bonds and put options, would all be prohibited under the proposed law. The CDS contracts are to be designated in Indian Rupee and settled.

Scheduled Commercial Banks (not including banks of payments, Small Finance Banks, Regional Rural Banks, Regional Local Area Banks) and Non-Banking Financial Companies (NBFCs) comprising Housing Stand-Level Primary Dealers (SPDs), Finance Companies (HFCs), National Housing Bank (NHB). (NABARD), Exim Bank and SIDBI will b) The categorization of the user under the proposed rules would take account of the market maker's retail or non-retail users. All qualified users other than non-retail users are considered retailers.

Some standards will be observed in the reporting part of the transactions. The credit derivatives manufacturers must inform the Clearing Corporation of India Ltd. (CCIL) of transactions within 30 minutes and provide a clear statement whether the transaction is for hedging or for other purposes. The CCIL serves as the commercial repository. The CDS contract should be reported to the CCIL from one market participant to another. A Fixed Income Money Market and Derivatives Association of India (FIMMDA), which would also comprise of other market players, would establish a credit derivatives determination committee (CDDC). Furthermore, the FIMMDA will lay out the norms and regulations on the best international practises for CDDC's operations. In the different market participants, the CDDC pronouncements are binding.

The directive on registered exchanges relates to the offering of single-name CDS contracts with cash payment. Retail

consumers will only start business in the CDS in order to cover the underlying credit risk. Reference entities and reference duties must comply with the requirements specified. The CDDC assesses the incidence of credit events for the exchange traded CDS. The RBI must give authorization to conclude or amend the Product, registrants or other aspects of CDS contracts, in accordance with the regulations, before an exchange takes place. Moreover, the exchanges guarantee that participants are informed of CDS-related risks. International portfolio investors (IPI), after receiving consent of the regulatory body concerned, may participate in transaction CDS as securities sellers or purchasers. The exchanges will disclose all CDS transactions to a trading repository in accordance with RBI instructions. In addition, the rules mandate that exchanges provide information for the RBI or any other agency, as defined by the RBI, within a certain timeframe[10].

### 1.4 Default Credit Swaps

The single name credit default swaps have been the focus of debate in the aforementioned remarks of the RBI. What are CDS? What are CDS? It is a credit derivative tool ready to cover the risk of default for an underlying financial asset. The derivative mechanism seems to be that, in the event of a credit event, the protective seller will reimburse the buyer only for a swap premium paid when the contract was initiated. Protective purchasers pay protection sellers a swap premium for CDS again in exchange for an agreement which depends on reference obligations or benchmark entity or benchmark entity payment. Prime legs are often described as payments made primarily by the protective buyer, while the protective legs are characterised as payments made by the provider.

## 2. DISCUSSION

The literature on credit derivatives is in an emerging stage. The idea is mostly based on academic research, with few market players and banks involved. This part of the literature review understands the history and consequences of credit derivatives throughout the years and the current situation. But we must grasp the idea of derivatives, much alone credit derivatives, before this. If we consider the roots of derivatives it may be closely connected to the insurance idea that refers to financial covering for any specific risk and insecurity that the insurer gives the policyholders when the insurer regularly pays the premium for a set time in the corresponding coverage. The insurers' role may therefore be classified in two categories, i.e. risk carrying and i. risk pooling. By expanding the number of policyholders the risk for insurers would be spread. The idea of credit derivatives is in some way identical to the insurance when credit risk, interest rate risk, counterparty risks etc. are transferred in expectation of their portfolio diversification and improved yield to another business ready to invest in these financial instruments. In addition to that, the entity is obligated to pay upon occurrence of a credit event such as default, non-payment, bankruptcy etc. based on the credit derivative scheme, for example, credit default swaps, where payments are paid to companies who bought CDS if the reference asset defaults. Derivatives are therefore a kind of financial instrument designed to protect against unwanted financial changes.

Initially, RBI Apex Bank had a strategy to introduce CDS in 2008, but it had to hold back in the global financial crisis due to growing worries over the same instruments. This has given a thorough knowledge of credit default swaps and collateral debt obligations, which have contributed significantly to the financial

catastrophe. This enabled RBI to get a thorough perspective of the subject and postpone the launch of the Indian credit derivatives market. Although credit derivatives offer an option to hedge the credit risk, it does not provide a fool proof method to prevent risk at source (example of sub-prime loans and mortgages). The RBI has averted numerous lapses and failures by defining the rules so that history is not repeated again. Industry analysts applauded the decision since India lagged behind in this area of financial innovation. However, certain limitations, such as the CDS contract, must only be resolved in Indian Rupee. As soon as the market functions start, the establishment of commercial repositories and other elements of the rules must be revised. Another element that has to be noted is how different market players are involved in the credit derivatives market.

## 3. CONCLUSION

As outlined in the draught guidelines, the regulatory framework established by the RBI emphasises the transparent and responsible process and is promising. In Indian banking, the increasing non-performing assets and other additional hazards provide different credit risk problems, where credit derivative markets offer a new option to transfer the risk. In addition, by investing in credit derivative markets with expectation of higher yields otherwise not accessible before, other financial institutions such as insurance undertakings, mutual funds, NBFCs and many more may diversify their portfolios. Last but not least, credit derivatives should not be considered the solution for the management of credit risk because the previous consequences of their improper usage must not always be remembered.

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