ANALYZING THE RISKS INVOLVED IN OVER-THE-COUNTER DERIVATIVES CONTRACTS

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I. INTRODUCTION

A derivative is a risk transfer agreement whose value is derived from the value of an underlying asset. The underlying asset could be a physical commodity, an interest rate, a company's stock, a stock index, a currency, or virtually any other tradable instrument upon which two parties can agree. Derivatives fall into two major categories. One consists of customized, privately negotiated derivatives, which are known as over-the-counter (OTC) derivatives. The other category consists of standardized, exchange-traded derivatives. To define OTC derivative, it is a bilateral, privately-negotiated agreement that transfers risk from one party to the other. The derivatives which are transacted OTC are Foreign Exchange Forwards, Interest rate swaps, currency swaps, credit default swaps etc.

The exchange traded derivatives such as the Futures are regulated by the Clearing house of the Stock exchanges and the transactions are transparent in nature but in case of OTC Derivatives there is no one centralized agency looking after the transactions, hence there is a risk of Counterparty. The opaque nature of OTC transactions also leads to Systemic risk, where the failure of one entity becomes the cause of failure of entire market, which was observed in the recent financial crisis. Steps are being taken at international level to introduce regulatory reforms for OTC derivatives to mitigate the risks involved in these types of transactions. India on the other hand is already regulating OTC transactions. RBI is the regulatory authority and CCIL is the clearing house which looks after the OTC transactions. But the CCIL is equipped with too much of financial activities and its failure to regulate the OTC market may prove to be too dangerous for the Indian market.

This article therefore tends to make a detailed analysis of the risks involved in OTC derivatives contracts and the effects which these risk can cause to the financial institution, investors etc. The article will also discuss the regulatory steps taken up by India and various other jurisdictions to

mitigate these risks and in Indian context the effect of the regulations governing the OTC market will be discussed.

II. OVER THE COUNTER DERIVATIVES: AN OVERVIEW

Derivatives transaction is a bilateral contract or payments exchange whose value derives, as its name implies, from the value of an underlying asset or underlying rate or index.[1] Today, Derivatives cover a broad range of underlying such as exchange rates, commodities, equities and other indices. Derivatives transactions falls into two categories-one which are standardized and are transacted over the exchange, the other is customized, privately negotiated derivatives which are generally known as over-the-counter (OTC) derivatives. This article focuses only on OTC kinds of derivatives contracts.

OTC derivatives contracts are majorly transacted derivatives in the world. It is a major source of earnings for the world's largest commercial banks and securities firms which are active dealers in these markets.[2] OTC transactions are most favoured by the investors around the globe due to the advantages attached to these type of transactions and this has led to the growth of global OTC market against its exchange traded counterpart. The OTC contracts outnumber the exchange traded contracts in terms of size as well as in terms of its relative position. The Bank for International Settlements (BIS) estimates that the total notional amount outstanding of OTC derivatives contracts by end-June 2012 is $639 trillion, which in the year 1998 was $78 trillion.[3]

It is important to note few historical aspects which led to the development of OTC market around the globe and paved the way for this OTC market to become one of the most transacted markets. The history of Derivatives Transactions can be traced back to 1634 in Holland where demand for tulips massively exceeded supply and prices soared and as a result of this a Futures Market emerged where tulip bulbs were brought and sold while they were still in ground.[4] Another Futures Market can be traced back to 1650 in Osaka, Japan where rice was traded as future commodity.[5] The rice bills represented the right to take up the delivery of the agreed quantity of

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[1] Derivatives: Practices and Principles, 1993, p 28, Global Derivatives Study, Group of the Group of Thirty.

[2] Michael R. Darby, Over-The-Counter Derivatives and Systemic Risk to the Global Financial System, July 1994, Working Paper No. 4801, National Bureau of Economic Research available at http://www.nber.org/papers/w4801.pdf

[3] Semiannual OTC derivatives statistics at end-June 2012, Bank for International Settlements, available at http://www.bis.org/statistics/otcder/dt1920a.pdf.

[4] Simon James, The Law of Derivatives, 1999, p 1, LLP Reference Publishing.

[5] Don, Chance, Essays in Derivatives: A Brief History of Derivatives, 1998, John Wiley & Sons.

rice at a future date but at a current price.[6] The major breakthrough in the history of Derivatives Transaction was noted in 1848 with the establishment of Chicago Board of Trade. Chicago was one of the major hubs for the storage, sale and distribution of a type of grain, the storage facilities were unable to accommodate massive supply of grain which was followed after the seasonal harvest and to overcome this, a group of grain traders created 'to-arrive' contract which provided that the farmers can lock the price of the grain and can deliver the grain at the Chicago storages later at the earlier fixed price.[7] This form of contract, because of its efficiency and profitability was observed and followed by many other traders. These 'to-arrive' contract proved useful device to minimize or eliminate the risks, also known as hedging and speculation on price changes on commodities. The history of derivatives also provides evidence that the first derivatives market were over-the-counter (OTC).[8] Due to technological development, most of the derivatives contracts started being traded on the electronic exchanges but this electronic form of trading did not bar the OTC transactions, rather the OTC market developed at a greater rate than the exchange traded derivatives. The Bank for International Settlements estimates that the global OTC derivatives contracts are about eight times greater than the equivalent exchange traded derivatives.[9] This enormous growth and size of the OTC market has attracted investors to invest in this type of market. The main advantages attached are the customization of the terms of contract, where the parties can set their own set of rules for guiding the contract which is not available in exchange traded derivatives, as the contract is set by the exchanges itself and the exchange act as counterparty.

1. Over-The-Counter Traded Derivatives:

The derivatives which are traded over-the counter are:

i) **Forward Contracts:** Forwards are financial contracts in which two counterparties agree to exchange a specified amount of designated product for a specified price on a specified future date or dates.[10] Forwards contract are privately negotiated bilateral contract and differ from Futures type of derivatives in that their terms are not

[6] Steve Kummer, Christian Pauletto, The History of Derivatives: A Few Milestones, EFTA Seminar on Regulation of Derivatives Markets, Zurich, 3 May 2012.
[7] *Supra* Note 6.
[8] *Supra* Note 7.
[9] Exchange-traded derivatives Notional Amounts Statistics, Bank for International Settlements, available at http://www.bis.org/publ/qtrpdf/r_qa1303_anx23a.pdf
[10] Alan N. Rechschaffen, Capital Markets, Derivatives and the Law, 2009, p 166, Oxford University Press.

standardized and they are not traded on organized exchanges.[11] Because they are individually negotiated between counterparties, forwards can be customized to meet the specific needs of the contracting parties. Forward Rate Agreements (FRAs) are the most common type of forward contracts traded off-exchange.

ii) **Foreign Exchange Forwards:** In an over-the-counter foreign exchange forward agreement, two parties agree to exchange a notional amount of capital in one currency valued in a different currency at a designated exchange are on a specified future date.[12] The exchange rate specified in a foreign exchange forward normally differs from the spot exchange rate.

iii) **Swaps:** A swap is an OTC derivatives contract in which two parties agree to exchange 'cash flows' on a 'notional amount' over a period of time in the future.[13] The different types of OTC traded swaps are:

- **a.** Interest Rate Swaps
- **b.** Currency Swaps
- **c.** Commodity Swaps
- **d.** Equity Swaps

iv) **Credit Default Swap (CDS):** It is a type of Swap where credit exposure of fixed income is transferred between the parties. It is also knows as Credit Derivative Contract. The purchaser in this type of contract makes payments to the seller of the swap till its maturity date. The seller, in return promises to pay off a third party debt if that third party fails to repay the loan. In this way, the buyer of CDS gets a protection as there is a chance that the third party may default on payment of loan, but since it had bought the CDS from the seller against that loan, the risk of losing the money is shifted from the buyer to the seller of the CDS and in default by the third party, the seller of CDS has to payback the loan to the buyer. CDS is also considered as insurance to the buyer against the non-payment by the third party.

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[11] The Economic purposes of Futures Markets and How they Work, Commodity Futures Trading Commission, available at http://www.cftc.gov/educationcenter/economicpurpose.html.

[12] *Supra* Note 11.

[13] *Id.*

2. OTC Market in India:

In pre-independence era, the OTC contracts were prevalent in India but the Securities Contract Regulation Act, 1956 (SCRA) banned all kind of derivatives trading. The reason behind the prohibition of derivatives trading in India was to prevent undesirable speculation in securities.[14] The stock market reforms between 1993 and 1995 helped paving the way for the development of derivatives market in India, especially the exchange traded equity derivatives. The establishment of NSE in the year 1993, which is known for the improvement of transparency and efficiency in the stock markets since it provided automatic screen-based trading system where the price of the stocks were disseminated in real-time, the lifting of ban on trading on options in the year 1995 were the important events for derivatives markets in India. In 1996 the L.C. Gupta Committee was set up by SEBI to look into appropriate regulatory framework for trading of Derivatives. Another committee was constituted under the chairmanship of J.R. Varma, known as the Varma Committee 1998 to recommend risk containment measures for derivatives trading.[15]

Both the committees were of the view that if derivatives contracts are to be traded in Indian market, then the appropriate place is the recognized stock exchange due to transparency, their ability for risk management and they are also equipped to undertake the trading activities of derivatives.[16]

Following the recommendations of the two specialized committees set up to look into the Derivatives trading in India, the ban on derivatives trading was revoked and a number of derivatives such as currency swaps, currency options, interest rate and commodities Futures were introduced. And in the year 1999, the Securities Contracts (Regulation) Act, 1956 was amended and the definition of 'securities' under the Act now also included 'derivatives'.[17] The amendment allowed the regulatory framework applicable to the trading of securities to be extended to derivatives trading.

The trading of Futures started in June 2000 which was followed by trading of stock index Options, stock Options and single stock Futures. But the Act considered trading of derivatives legal and valid only if they are traded on exchanges. It provided that the validity of the

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[14] Shashank Saksena, Legal Aspects of Derivatives Trading in India, available at http://www.iief.com/Research/CHAP14.PDF

[15] *Id.*

[16] Sumon Kumar Bhaumik, The L.C. Gupta Committee Report: Some Observations, July-September, 1998, Money & Finance, available at http://www.icra.in/Files/MoneyFinance/JulSep1998LCGupta.pdf

[17] Section 2(h) (ia), Securities Contracts (Regulation) Act, 1956.

derivatives contracts will depend on the fact that such contracts are traded on a recognized stock exchange and are settled on the clearing house of the recognized stock exchange accordance with the rules and bye-laws of such stock exchange.[18] This precluded the trading of OTC derivatives in Indian market. The L.C. Gupta Committee also recommended the same that for the purpose of transparency, the derivatives market should be traded on a stock exchange.[19] In India, therefore, OTC derivatives are generally prohibited from being traded in the market. But there are exceptions to this general scenario, some OTC are specifically allowed by the Reserve Bank of India (RBI) and in case of commodities, which are regulated by the Forward Markets Commission[20], those that are traded informally in 'havala' markets or Forward markets.[21] In the year 1999, the trading of OTC derivatives was initiated formally by the RBI guidelines. The guidelines by RBI provided for trading of two types of OTC derivatives in India: Interest Rate Swaps (IRS) and Forward Rate Agreements.[22]

III. RISKS INVOLVED

Derivatives contracts are entered into to reduce the risks, but the risks discussed in this context are economic risks, such as the risk that the price of certain commodity will raise or fall, or the interest rates may become high or low. But there are also legal risks which the parties to the contract may face. The entry into an OTC derivatives contract necessary entails taking on certain type of legal risks, such as in legal perspective the risk that the contract will not be able to achieve its goal or it will achieve for whatever it was made to achieve with undue delay or cost, or the contract being wholly unenforceable and ambiguous and requires third party involvement for resolving the issues.[23] The opaque nature of OTC transactions gives rise to many risks which may prove to be too harmful for the entities entering into contract and may also trigger economic instability.

The risks involved in Over-the-counter derivatives contracts are:

i) Counterparty Risk:

[18] Section 18A, Securities Contracts (Regulation) Act, 1956

[19] *Supra* Note 14.

[20] Forward Markets Commission: It is a statutory body set up under the Forward Contracts (Regulation) Act, 1952 and is a chief regulator of Forward and Futures market in India, see http://www.fmc.gov.in

[21] Asani Sarkar, Indian Derivatives Market, available at http://www.newyorkfed.org/research/economists/sarkar/derivatives_in_india.pdf

[22] Guidelines of RBI regarding IRS and FRA available at http://rbidocs.rbi.org.in/rdocs/notification/PDFs/59361.pdf

[23] *Supra* Note 5.

This is the largest category of risk under the OTC derivatives contracts. At the time of contracting OTC derivatives, the important risk that needs to be evaluated is the risk that the counterparty will not fulfill its future obligation or the party may default in fulfilling its contractual obligations, thereby resulting in a loss. It becomes difficult to evaluate this type of risk because the exposure of the counterparties involved in the contract, to various risks is generally not public information.[24] In exchange-traded derivatives there is a central clearinghouse which is regulated by some rules and bye-laws, which stands as a guarantee to the buyer and seller that their trades will not be affected by the default. The key feature of OTC market is its opacity. The market transactions are not transparent and therefore are not subjected to any regulation. Even the specific contracts in OTC nature cannot be precluded from this risk, for example in Credit Default Swaps (CDS), the trading parties entering in the contract does not possess full knowledge about the position of the other party in financial or in any other terms. Such opaque nature of the market, where exposures to the financial credentials are less or there is lack of position transparency leads to Counterparty Risk.

The other factor involved with this risk is of Capacity which is called Counterparty risk externality. This relates to the Capacity of a party to enter into contract on a particular subject. It is observed when a counterparty agent had entered into a contract with one party, enters into contract with another agent, the earlier party may be at risk with respect to his contract because the default risk on the earlier contract is increased and the probability that the counterparty will perform the earlier contract decreases and the chances of that earlier contract being at default increases.[25] For example, externality will arise if an insurance agent has sold few insurances, sells more insurances to other agents. The same happened with the insurance giant American Insurance Group (AIG) in the year 2008; its liquidity position became week when the company had written Credit Default Swaps (CDS) for many investors and the company gave the guarantee for protection against any kind of default on mortgage-backed products. The investors realized that the value of the protection provided by AIG reduced dramatically on individual guarantee. With inadequate liquidity, the Government had to take over AIG to support it which otherwise would have resulted in a global crisis. The opaque nature of OTC derivatives in which these

[24] Viral Acharya, Alberto Bisin, Counterparty risk externality: Centralized versus over-the-counter markets, December 2011, New York University, available at http://www.econ.nyu.edu/user/bisina/OTC%20theory_ab.pdf

[25] *Id.*

CDS were traded is blamed for this incident which allowed the build-up of such large exposures.[26]

ii) Transaction Risk:

Transaction Risk encompasses the actions taken while entering into a transaction. OTC derivatives contracts are privately negotiated contracts and the terms and condition such contract can be set as per the requirement of the parties. While negotiating the contract, issue may arise regarding the general legal requirements. For example, any kind of misrepresentation at the time of negotiating and entering into the contract may give one of the counterparty a right to rescind the contract or to claim damages out of the same. A transaction risk may also occur when the contract is not concluded in an appropriate manner, for example if the contract is concluded on the telephone without any documentation or signed papers, then in the absence of detailed items creates a transaction risk because one of the parties may not avail the remedy in case of any default by the other party, which a drafted contract would provide.[27]

iii) Systemic Risk:

Systemic Risk can be defined as:

> *"illiquidity or failure of one institution, and its resulting inability to meet its obligations when due, will lead to the illiquidity or failure of other institutions"*[28]

This risk is also attached to one of the key characteristics of OTC, its opaque nature. Any kind of upheaval in the OTC derivatives market can adversely affect the financial stability of the market. This can happen when a large and strong financial dealer, such as Banks, Insurance Companies are unable to meet their contractual obligations and spreading significant losses to other financial institutions, resulting in a domino effect and thus creating a systemic fall among other financial dealers.[29] For examples, the AIG incident mitigated systemic risk and it is said to have played a key role in 2008 financial crisis. The inadequate liquidity in the market and the market confidence reduced significantly, the other financial institutions attached with AIG got effected

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[26] Adam Davidson, How AIG fell apart?, September 2008, Reuters, available at http://www.reuters.com/article/2008/09/18/us-how-aig-fell-apart-idUSMAR85972720080918

[27] *Supra* Note 5.

[28] Bank For International Settlements, Report of The Committee On Interbank Netting Schemes of The Group of Ten Countries, November 1990, available at http://www.bis.org/publ/cpss04.htm.

[29] Stephen Lipin & William Power, Derivatives Draw Warning from Regulators, The Wall Street Journal, March 25, 1992, p. C1.

to a greater extent, thus resulting in systemic crisis.[30] Also, even if the large financial dealers are not on the edge of financial instability, but the fear of their failure might cause flight out of its derivatives portfolio and this might increase the likelihood of an actual financial crisis.[31] The OTC derivatives has posed serious systemic risk around the globe, since major banks are involved in OTC derivative transaction and the financial failure on their part can harm the market stability and may trigger a global financial crisis.

IV. NEED FOR REGULATORY NORMS

Although the trading of Derivatives contracts has contributed to a great extent in financial innovation and market efficiency, but the same market has also demonstrated in recent past that it is capable of aggravating the financial distress prevailing in the economy.[32] Over the years, the OTC derivatives have provided a flexible tool for the investors to hedge large number of risks. The Forwards and the Swap market had grown to all new levels but then the growth was followed by the 2008 financial crisis. The economists and critics blame this ever-seen growth of Swaps, which are traded off-exchange, for triggering the financial crisis. The report of the Financial Crisis Inquiry Commission (FCIC) on stating the reasons for the 2008 Crisis concluded that over-the-counter derivatives contributed significantly to crisis.[33] The opaque structure of these OTC derivatives and lightly regulated phenomenon posed serious risks to the economic system. The FCIC stated that without any oversight, OTC derivatives rapidly spiraled out of control and out of sight, growing to $600 trillion in notional amount.[34] It is argued that the OTC markets have to be shifted from its opaque character to be a transparent one and also to make it safer and resilient.

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[30] Nout Wellink, Mitigating Systematic Risk in OTC Derivative Markets, July 2010, Banque de France, Financial Stability Review No. 14, Derivatives – Financial innovation and stability, available at http://www.banque-france.fr/fileadmin/user_upload/banque_de_france/publications/Revue_de_la_stabilite_financiere/etude15_rsf_1007.pdf

[31] *Id.*

[32] Miguel A. Segoviano and Manmohan Singh, Counterparty Risk in the Over-The-Counter Derivatives Market, November 2008, IMF Working paper WP/08/258, available at www.imf.org/external/pubs/ft/wp/2008/wp08258.pdf

[33] The Financial Crisis Inquiry Report, Final Report of The National Commission on The Causes of The Financial And Economic Crisis In The United States, p 11, January 2011, available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf

[34] *Id.*

Following the financial crisis the G-20 Nations agreed to implement series of measures to regulate OTC derivatives and to mitigate systematic risk. In 2009, the G-20 leaders in a conference in Pittsburgh agreed that:

> *"All standardized OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non centrally cleared contracts should be subject to higher capital requirements."*[35]

The Financial Stability Board (FSB) was given the responsibility to access the implementation and to work upon the recommendations to improve transparency in the derivatives market, protect against market abuse and mitigate systemic risk.[36] The FSB in its report highly recommended that like the exchange traded derivatives, the OTC trading should also be standardized, which will provide a clear picture of the transactions to the concerned parties and it will also help the regulators to regulate the transactions in a better way thereby helping in mitigating the risks. The main recommendations of the FSB for regulating the OTC trading are:

1. ***Central Counterparties:***

The FSB in its report in 2010 recommended that the trading of OTC derivatives be shifted to a centralized clearing house which would help mitigating systemic risk by improving counterparty credit risk management, reducing uncertainty about the financial conditions of the participants' exposures, and increasing the transparency of the transactions in the market.[37] Hence the introduction of Centralized Counterparties (CCPs) was recommended. CCP is a highly effective way to manage counterparty risk and other operational risk in the financial market. The CCPs mutualise the risk of the counterparty, as the counterparties will be subjected to a centralized agency, the agency will help in mitigating the risk through the use of pre-funded default and guaranty funds and the CCPs also manage credit risk as it will be linked with all the counterparties.[38] The establishment of CCPs will reduce uncertainty among the participants and

[35] OTC Derivatives Market Reforms Fourth Progress Report on Implementation, 31 October 2012, Financial Stability Board (FSB), available at http://www.financialstabilityboard.org/publications/r_121031a.pdf
[36] *Id.*
[37] Implementing OTC Derivatives Market Reforms, 25 October 2010, Financial Stability Board, available at http://www.financialstabilityboard.org/publications/r_101025.pdf
[38] *Id.*

will also provide the regulators with a clear picture of the transactions and financial condition of the OTC market.

2. ***Trading Platforms:***

The FSB also recommended the establishment of 'Organized platforms' i.e. electronic trading platforms for trading of OTC derivatives. However trading OTC derivatives in an organized platform will shift the core feature of an OTC derivative, which is to trade over the counter and not on a platform where the value of a derivative may be easily speculated by many. Trading OTC on an organized platform may also affect the liquidity and prices as they may be beneficial for some participants while not for others, therefore the recommendation by FSB on establishing organized platforms for the trading of OTC derivatives must be carefully considered as it can have the effect of changing the very nature of OTC trading. But if an organized trading platform is created, taking into account the main feature of OTC trading, the platform may prove to be too good as it will increase the transparency of transaction which otherwise is not there in the conventional OTC trading.

3. ***Trade Repositories:***

The current trading of OTC does not allow the regulators to have a clear picture about the transactions taking place or the credit risk faced by the participants. During market instability, this feature of OTC trading may prove to be dangerous as the regulators will not be able to see the amount transacted or the amount which is faced by credit risk. Hence the FSB recommended that to centralize the collection of transactions in OTC trading and to disseminate the information at regular intervals, Trade Repositories should be formed. These Trade Repositories can be very helpful for the authorities; market participants and public as it will provide a credible source of data on OTC derivatives. It will also support risk reduction and it will help improving the operational efficiency of the transactions.

These recommendations by the FSB are in the line of improving and regulating the OTC market which in the current form is not very well regulated and the counterparties entering into the transactions are at continuous credit risk. The financial crisis of 2008 and the debatable nature of OTC transactions have led many jurisdictions to incorporate these recommendations in their municipal law. For example the US Government had passed Dodd–Frank Wall Street Reform and Consumer Protection Act in mid 2010 to provide transparency and to reduce the risks which

are associated with OTC transactions. In European Union, the European Market Infrastructure Regulation (EMIR), was agreed in February 2012 for regulating the OTC derivatives. However both these regulatory initiatives by US and EU are in the initial stage and have not been implemented with full effect. In Japan, the Financial Instruments and Exchange Act was passed in May 2010, which gave the authority to the Japanese Financial Services Agency (JFSA) to regulate OTC derivatives. Similar regulations were passed in Hong Kong, Singapore and Canada, on the recommendations by FSB. The Council of Financial Regulations of Australia in its report on *OTC Derivatives Market Reform Considerations* recommended the same regulatory reforms as provided by the FSB.[39]

However, the market response to these recommendations and regulations has been negative. The industry is said to be unprepared for these new reforms aimed at regulating the OTC transactions. According to a study, which surveyed responses from hedge funds, investment banks, broker-dealers and exchanges, 36% of the firms dealing in OTC derivatives are not in any place to deal with the new regulatory reforms and 62% were only slightly prepared.[40]

V. LEGAL SCENARIO IN INDIA

The RBI guidelines in the year 1999 paved the way for OTC transaction in India. The two OTC derivatives which permitted were: Interest Rate Swap (IRS) and Forward Rate Agreements (FRAs). Section 45W of the Reserve Bank of India Act, 1936 empowers RBI to regulate the OTC derivatives market in India. Hence all the exchange-traded derivatives are regulated by respective exchanges such as Bombay Stock Exchange, National Stock Exchange and are overlooked by Securities and Exchange Board of India (SEBI) and on the other hand the OTC derivatives are within the purview of the RBI. With the Reserve Bank of India (Amendment) Act, 2006, Foreign Exchange (FX) derivatives such as FX forward, options and swaps were also allowed. The Amendment Act also declared that one of the counterparty entering into an OTC contract has to be a RBI regulated entity. Hence the year 2006 marked the major developments in regulations regarding OTC derivatives in India.

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[39] Report by Council of Financial Regulations of Australia on OTC Derivatives Market Reform Considerations, available at http://www.treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2012/CFR%20report%20on%20over%20the%20counter%20derivatives/Downloads/PDF/CFR%20Report.ashx

[40] Industry Still Not Ready For OTC Derivatives Reforms**,** January 30, 2013, available at http://marketsmedia.com/firms-still-not-ready-for-otc-derivatives-reforms/

Clearing Corporation of India Ltd. (CCIL):

The fact which is to be appreciated about the Indian regulatory system of OTC derivatives is the establishment of the Centralized Counterparty in the form of CCIL way before when the financial crisis of 2008 hit the globe and an urgent need for a Central Counterparty was called for. The CCIL, promoted by the leading Banks and other financial institutions of India was established in the year 2002 to improve the efficiency and to provide safeguard to debt and forex markets in India. The RBI in its notification in the year 2007 state that "it is necessary to have a mechanism for transparent capture and dissemination of trade information as well as an efficient post trade processing infrastructure for transactions in OTC interest rate derivatives, to address the attendant risks".[41] Hence the CCIL started acting as a Trade Repository for OTC trading in case of IRS and FRA derivatives. In July 2012, the CCIL launched the Trade Depositories for Forex Derivatives-FX Forwards, Options and Swaps.[42] The CCIL captures the transactions of trading of OTC derivatives through a reporting platform. Within 30 minutes of the IRS/FRA trades, all banks and Primary Dealers have to report the transaction on the reporting platform of CCIL. At present the CCIL maintains a centralised electronic database of OTC derivatives transaction data involving IRS/FRAs and FX Forwards, Options and Swaps, thereby providing a ringside view of market concentration, which helps in risk reduction.[43]

The RBI closely monitors the activities of CCIL. To rule out any possibility of CCIL not being able to fulfill its obligation of honouring a contract, the CCIL Regulations mandates that it maintains a guarantee fund and has adequate lines of credit arrangements with various banks to ensure funds settlement on guaranteed basis.[44] Hence the CCIL act as Central Counterparty which reduces the risk of Counterparty and regular recording of transactions regarding OTC trading, which are also overlooked by RBI, provides the transparency thus reducing the

[41] Reporting Platform for OTC Interest Rate Derivatives, Reserve Bank of India, August 23, 2007, available at http://rbi.org.in/scripts/NotificationUser.aspx?Id=3780&Mode=0

[42] Launch of the OTC Derivatives Trade Repository, Reserve Bank of India, July 11, 2012, available at http://rbi.org.in/scripts/BS_SpeechesView.aspx?Id=701

[43] Clearing Corporation of India launches trade repository for OTC Forex Derivatives, July 9, 2012, The Economic Times, available at http://articles.economictimes.indiatimes.com/2012-07-09/news/32604642_1_ccil-inter-bank-forex-trade-repository

[44] The Clearing Corporation of India Limited Regulations (Forex Forward Segment), available at https://www.ccilindia.com/Membership/ByLawsDocs/FFS%20REGULATION%20FINAL030711.pdf

systematic risks. [45]Though the CCIL is acting as a protective guard and helps in mitigating the risks involved in OTC transactions, however the Committee on Financial Sector Assessment (CFSA) set up by the Government of India and the Reserve Bank reports that the CCIL is equipped with wide spectrum of financial activities leading to concentration of risks in one entity and the report also stated that the risk management of CCIL is not adequate and in case of destabilizing, this may have a wide implication in the market.

Since CCIL is the only clearing house in the country, it is opined that competition should be allowed in this sector much like NSE and MCX compete in exchange-based CCPs, by allowing the entry of more CCPs which help increasing operational efficiency and will also reduce the concentration of risks.[46]

VI. CONCLUSION

The OTC derivatives market around the world grew at a much faster pace in the last two decades against its exchange-traded counterpart. The outstanding notional amount reached to the level of more than $600 trillion. The advantages attached with this kind of derivative contract attract lots of investors, banks, insurance companies and other financial institution. So being the profit and hedging involved in OTC transactions that its opaque nature was not considered as its limitation rather it was considered as one of its feature. The risks involved in this type of trading can trigger destabilization of not just one entity or one bank but the systemic risk involved in OTC trading can cause a big financial instability. The financial crisis of 2008 proved to be too heavy for the OTC market. The economists, the critics, the financial regulators of the world blamed OTC derivatives transactions as one of the reasons for the global meltdown. In the wake of this financial crisis the countries of the world had decided to introduce regulatory reforms in the form of Central Counterparty, Trade Repository etc. This will not only help mitigating risk but will also encourage the investors and develop the market as a whole. However many nations are still reluctant to introduce such reforms. The developed nations such as US and in EU have introduced regulations but are not yet implemented with full effect.

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[45] CFSA Reports Released : Financial Sector Self Assessment finds System Broadly Robust but Identifies Specific Concerns, March 30, 2009, Reserve Bank of India, available at http://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=20428

[46] Dayanand Arora Francis Xavier Rathinam, OTC Derivatives Market in India: Recent Regulatory Initiatives and Open Issues for Market Stability and Development, April 2010, Indian Council For Research On International Economic Relations

In case of India, the introduction of CCIL did much of the job for mitigating Counterparty risk and Systemic Risk. The RBI act as a watchdog in OTC market transactions. Hence the dual guard provided by the RBI and CCIL safeguards the interest of the investors and also encourages greater market participation with respect to OTC derivatives. However as noted, CCIL is tasked with too much financial duties and also lack risk management system. Since all of the OTC market is dependent on CCIL, any destabilization from the side of CCIL may prove to be dangerous for the market as well as for the economy. Hence the introduction of new CCPs should be encouraged by the Government which will not only distribute the financial activity burden but in the form of competition will provide operational efficiency and better risk management mechanism.