CIRCULAR

SEBI/HO/IMD/PoD2/P/CIR/2024/125 **September 20, 2024**

All Mutual Funds/
All Asset Management Companies (AMCs)/
All Trustee Companies/ Board of Trustees of Mutual Funds/
Association of Mutual Funds in India (AMFI)

Sir / Madam,

Subject: Flexibility in participation of Mutual Funds in Credit Default Swaps (CDS)

1. Under the existing regulatory framework, Mutual Funds in India are permitted to participate in CDS transactions only as users i.e, to buy credit protection only to hedge the credit risk on corporate bonds held by them. Furthermore, such transactions can be currently undertaken by Mutual Funds only in the portfolios of Fixed Maturity Plans (FMP) schemes having tenor of more than one year.

2. Reserve Bank of India has issued a revised regulatory framework for CDS on February 10, 2022 "Master Direction – Reserve Bank of India (Credit Derivatives) Directions, 2022" in order to provide the necessary impetus for the development of CDS market by, inter alia, expanding the base of protection sellers including selling of protection by all major non-bank regulated entities including by Mutual Funds.

3. In view of the above, after taking into consideration the recommendations of the Working Group set up to deliberate on the issue, recommendations of Advisory Committee on Mutual Funds (MFAC), inputs by AMFI and feedback received on the consultation paper on this issue, it has been decided to allow greater flexibility to Mutual Funds to both buy and sell CDS with adequate risk management. Such flexibility to participate in CDS shall serve as an additional investment product for Mutual Funds and also aid in increasing liquidity in the corporate bond market.

4. Accordingly, clause 12.28 of the Master Circular for Mutual Funds dated June 27, 2024 stand modified as under:

12.28. Participation of Mutual Funds in Credit Default Swaps (CDS)

Mutual Fund Schemes as buyer of CDS

12.28.1. Schemes may buy CDS only for the purpose of hedging their credit risk on debt securities they hold in various schemes. The exposure of CDS shall not exceed respective debt security exposure, and such exposure may not be added to gross exposure of the scheme.

12.28.2. In case the protected debt security is sold, schemes shall ensure that the respective CDS position is closed within fifteen working days of selling the above protected debt security.

12.28.3. The exposure of any protected debt security, for determining single issuer, group, sectoral limits and credit risk for various purposes including Risk-o-meter and Potential Risk Class (PRC) matrix of MF schemes, shall be considered as exposure to either issuer of debt security (reference entity) or seller of CDS, whichever has higher credit rating (lowest long term rating of instruments of seller of CDS shall be considered for comparison).

The exposure shall form part of overall single issuer limits for the reference entity or seller of CDS, whichever is applicable.

In case of same rating for reference entity and seller of CDS, the exposure shall then be considered on reference entity and not on seller of CDS.

12.28.4. MF schemes shall buy CDS only from such sellers that have instruments with lowest long-term rating of investment grade and above.

12.28.5. Schemes may buy CDS for investment grade and existing below investment grade debt securities in the portfolio, if any.

Mutual Fund Schemes as seller of CDS

12.28.6. MF Schemes may sell CDS only as part of investment in synthetic debt securities, i.e., sell CDS on a reference obligation covered with Cash/G-Sec/T-bills. Overnight and Liquid schemes shall not sell CDS contracts.

12.28.7. The following shall be ensured with respect to the cover:

12.28.7.1. Cash, G-Sec and T-bills can act as cover. Government securities with maturity within +/- 6 months of the maturity of respective debt security (reference obligation) shall act as cover and such cover may be used for maintaining margin requirements on respective CDS.

12.28.7.2. The required amount of cover shall be enough to ensure that notional amount does not exceed the value of cover kept, which shall be calculated as follows:

- Notional amount in CDS sell contract
  (+)
- Buffer, for price fluctuations on government securities kept as cover: The buffer shall be calculated to address interest rate risk on government securities. The buffer shall be atleast equal to three times the daily haircut applicable for the said G-sec instrument in case of repo transactions on Clearing Corporation of India Limited.

12.28.7.3. The value of cover kept shall be reviewed on a daily basis.

12.28.7.4. The cover shall be earmarked to CDS sell position and can be used for maintaining margin requirements on respective CDS. However, investment in aforesaid instruments as cover shall not be considered as part of Liquidity Ratio – Redemption at Risk (LR-RaR) and Liquidity Ratio - Conditional Redemption at Risk (LR-CRaR) eligible instruments and shall not be sold or used for any other purpose till CDS sell position is open.

12.28.8. The exposure of synthetic debt security (notional amount) shall be considered in respective single issuer, group issuer and sectoral limits. Such exposure to the issuer, group and sector of the issuer shall be equal to the notional amount.

12.28.9. For the purpose of computing gross exposure of scheme investing in synthetic debt security, the exposure due to such investment shall be computed as follows:

- Notional amount
  (+)
- Buffer (i.e., cover kept over and above notional amount)

12.28.10. Schemes shall sell CDS only against securities rated investment grade and above.

12.28.11. Credit risk rating of the synthetic debt security shall be same as of reference obligation. For the purpose of Risk-o-meter, liquidity risk value of the synthetic debt security shall be

- Liquidity Risk Value of reference obligation + 2

12.28.12. For Potential Risk Class (PRC) matrix, Credit Risk Value shall be same as reference obligation.

12.28.13. **Debt Index funds and ETFs:** Such schemes may also take exposure through synthetic debt securities and the same may be treated as replication as required under clause 3.5.3 of the Master Circular.

Other conditions

12.28.14. Schemes shall comply with the directions issued by RBI from time to time in this regard.

12.28.15. Schemes shall participate in CDS only through standard contracts prescribed by Fixed Income Money Market and Derivatives Association of India (FIMMDA).

12.28.16. All CDS contracts shall be transacted either through Central Counterparty, if any or Request For Quote (RFQ) Platform.

12.28.17. MFs shall ensure Two-way Credit Support Annex (CSA) as part of CDS contracts.

12.28.18. The following disclosures shall be made by schemes in their periodic scheme portfolio disclosures:

12.28.18.1. Credit Rating of CDS seller (lowest long term) where CDS is bought by schemes

12.28.18.2. CDS transactions with associate or group companies of sponsor

12.28.19. CDS contract shall mature on or before winding up date of schemes, wherever applicable.

12.28.20. Exposure through CDS (Notional amount of both CDS bought and sold) shall not exceed 10% of AUM of scheme and shall be within the overall limit of derivatives exposure as prescribed in Scheme Information Documents.

12.28.21. **Valuation and Accounting:** AMFI, in consultation with SEBI, shall issue guidelines for valuation and accounting of CDS by MF schemes based on a waterfall approach, that may be as follows:

- Level I: Actual Traded levels
- Level II: Corporate bond credit spreads

5. The relevant changes in the Scheme Information Documents, basis the provisions of this circular, shall not be considered as a "Fundamental Attribute Change" of the scheme in terms of regulation 18(15A) of SEBI (Mutual Funds) Regulations, 1996.

6. The provisions of this circular shall come into force with immediate effect.

7. This circular is issued in exercise of powers conferred under Section 11 (1) of the Securities and Exchange Board of India Act, 1992, read with the provisions of regulation 43 (1) and regulation 77 of SEBI (Mutual Funds) Regulations, 1996, to protect the interest of investors in securities and to promote the development of, and to regulate the securities market.

8. This Circular is available at www.sebi.gov.in under the link "Legal > Circulars".

Yours faithfully,

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