ABM CHAPTER 23 PART 2

Credit Default Swaps (CDS) Explained 🔄

A **CDS** is a **bilateral agreement** between a **protection buyer (lender)** and a **protection seller (hedging institution)**.

✔ **Protection Buyer:** Pays a premium to **hedge against default risk**.

✔ **Protection Seller:** **Compensates the buyer** if the borrower defaults.

📌 **Key Features:**

✔ **Applicable to bonds and publicly traded debt** (not conventional bank loans).

✔ **Only the principal is covered** (interest is not protected).

✔ **Common credit events triggering CDS payout:**

- **Bankruptcy of borrower**
- **Failure to pay the loan**
- **Restructuring of debt**

📢 **Example of a CDS Transaction:**

1 **Bank of India lends ₹200 crore to Reliance Energy**.

2 The bank **fears default**, so it **buys a CDS** from ICICI Bank.

3 If **Reliance defaults, ICICI compensates Bank of India for the ₹200 crore loss**.

4 If **Reliance repays the loan fully**, **ICICI keeps the CDS premium paid**.

📌 Regulatory Guidelines (RBI):

✔ RBI allows **only plain vanilla CDS** (simple contracts with no complex structures).

✔ Banks **can only hedge their own loans, not speculate**.

Credit Linked Notes (CLN) 🔗

A **CLN** is a **structured debt instrument** where investors **bear the credit risk** of the borrower.

✔ **Banks transfer risk to investors** by issuing CLNs.

✔ Investors get **fixed/ variable returns** but **lose capital if the borrower defaults**.

✔ CLNs are managed by **Special Purpose Vehicles (SPVs)**.

🔷

🏦 **ABC Bank** – A big bank that has given a ₹100 crore loan to **XYZ Ltd.**
💰 **Investor (You)** – An investor looking for higher returns.
🏢 **XYZ Ltd.** – A company that took a loan from ABC Bank.

📌 **Step-by-Step CLN Process:**

Step 1: Bank Wants to Transfer Risk

- ABC Bank has given a loan of **₹100 crore to XYZ Ltd.**
- However, **ABC Bank is worried** that XYZ Ltd. **may not repay** (default).
- To **reduce its risk**, ABC Bank decides to **issue a Credit Linked Note (CLN)** to investors.

Step 2: Investor Buys the CLN

- You, as an investor, buy the **CLN issued by ABC Bank** for ₹100 crore.
- In return, **ABC Bank promises to pay you a fixed 10% interest per year** for the next 5 years.

Step 3: Two Possible Scenarios

✅ **Scenario 1: XYZ Ltd. Repays the Loan Successfully**

- XYZ Ltd. repays the ₹100 crore loan to ABC Bank.
- ABC Bank **returns your ₹100 crore investment** at the end of 5 years.
- You **earned 10% interest per year** for 5 years **without any loss**. 🎉

❌ **Scenario 2: XYZ Ltd. Defaults on the Loan**

- XYZ Ltd. **fails to repay the loan** (goes bankrupt).
- Since you took the **credit risk**, **you lose a part or all of your ₹100 crore investment**.
- You still received interest for some time, but the principal is now at risk.

Risk & Regulatory Concerns 🚨

📢 Why is RBI cautious about credit derivatives?

✔ **Risk Mispricing:** Banks may **underestimate actual credit risk**, leading to **incorrect pricing of CDS/CLNs**.

✔ **Speculative Trading:** If **banks sell CDS aggressively**, they **increase exposure to risk**.

✔ **2008 Financial Crisis: CDO and CDS misuse** led to the **global banking collapse**.

🔴 **RBI's Concern:**

"These derivatives are **complex financial weapons**—misuse could lead to a banking crisis." — Warren Buffet

📌 **RBI's Safeguards & Policies**

✔ **Only regulated institutions can trade CDS**.

✔ **Banks can hedge, but not speculate**.

✔ **Mandatory capital buffers** for risk coverage.

📌 Collateralized Debt Obligations (CDO)

Collateralized Debt Obligations (CDOs) are complex financial products that bundle multiple loans (like home loans, car loans, business loans) and sell them to investors. They help banks and financial institutions free up money for more lending while giving investors a way to earn returns.

🔹 **Features of CDOs**

✅ 📦 **Loan Bundling:** A CDO is made up of different types of loans, such as home loans, corporate loans, or credit card debt.

✅ 💰 **Sold to Investors:** These bundled loans are sold to investors who earn interest from them.

✅ 🔄 **Risk Transfer:** Banks reduce their risk by selling loans to investors.

✅ 🏆 **Different Risk Levels:** CDOs are divided into **tranches (sections)** based on risk – high, medium, and low.

🔷 **How Do CDOs Work? (Step-by-Step)**

🏦 **ABC Bank** – Issues home loans, car loans, business loans, etc.

💼 **Investment Firm** – Collects these loans and creates a CDO.

💰 **Investor (You)** – Buys the CDO for a return.

📌 **Step-by-Step CDO Process:**

Step 1: Banks Issue Loans

- ABC Bank gives **home loans, car loans, and business loans** to customers.
- The bank now has many loans on its balance sheet, and these loans generate **interest payments**.

Step 2: Bundling the Loans into a CDO

- ABC Bank **sells these loans to an Investment Firm**.
- The investment firm **bundles them into a single product** called a **CDO**.

Step 3: CDO is Split into Tranches (Risk Levels)

- The CDO is divided into **three levels (tranches)** based on risk:

🔷 **Senior Tranche (Low Risk, Low Return)** 🏅 – Gets paid first, safest investment.

🔷 **Mezzanine Tranche (Medium Risk, Medium Return)** ⚖️ – Paid after Senior Tranche.

🔷 **Equity Tranche (High Risk, High Return)** 🔥 – Gets paid last, highest risk but highest return.

Step 4: Investors Buy the CDO

You, as an investor, decide how much risk you can take:

- If you want **low risk**, buy the **Senior Tranche** (but get low returns).
- If you want **high returns**, buy the **Equity Tranche** (but risk losing your money if loans default).

Step 5: Loan Payments Flow to Investors

- Borrowers repay their home/car/business loans every month.
- The money flows into the CDO and is **distributed to investors based on their tranche level**.
- If some borrowers **fail to repay**, **Senior Tranche investors are protected**, but **Equity Tranche investors may lose money**.

🔷 Advantages of CDOs ✅

✔ **Diversification** – Invest in different types of loans in one product.

✔ **Higher Returns** – If loans perform well, investors earn good returns.

✔ **Banks Free Up Capital** – Banks can issue more loans after selling them in CDOs.

🔷 Disadvantages of CDOs ❌

❌ **High Risk of Default** – If many borrowers default, investors lose money.

❌ **Complex Structure** – Hard to understand for normal investors.

❌ **Market Crash Risk** – Bad CDOs caused the **2008 Financial Crisis**.

📌 RBI Guidelines on Credit Risk Management 🏦

The **Reserve Bank of India (RBI)** has outlined comprehensive guidelines to **strengthen credit risk management** in banks. These guidelines focus on **credit appraisal, risk mitigation, transparency, and oversight mechanisms**.

Guideline	Description	Objective
Independent Credit Appraisal	Banks should conduct their own credit assessments and not rely on external consultants.	**Reduce dependency** on biased credit reports.
Scenario Analysis for Infrastructure Projects	Conduct **sensitivity analysis** on project delays, cost overruns, and market risks.	**Improve risk prediction and financial planning.**
Scrutiny of Promoter's Equity Capital	Ensure **no debt is infused as equity capital** from parent company to subsidiary.	**Prevent manipulation** of financial ratios.
Verification of Directors (DIN/PAN)	Banks must check directors' **credit history** against the wilful defaulters' list.	Avoid lending to fraudulent borrowers.
Monitoring End-Use of Funds	Lenders must obtain **independent audits** on fund utilization.	Prevent **misuse and siphoning of funds**.

Board Oversight	**Proactive monitoring** of asset quality and timely **classification of wilful defaulters**.	Strengthen governance and risk controls.

Importance of Independent Credit Appraisal 🔎

📌 **RBI's Concern:**

- Many banks rely **only on external consultants** for credit evaluation.
- This leads to **biased loan assessments** and **high NPAs**.
- Banks **must conduct their own due diligence** before sanctioning loans.

📢 **Example:**

✅ **ICICI Bank** follows an **independent credit scoring model**, leading to lower NPAs.

❌ **Punjab & Sind Bank** faced **bad loan issues** due to excessive reliance on external consultants.

Risk Mitigation for Infrastructure Loans 🏗

🔍 **Scenario & Sensitivity Analysis:**

✔ Project **delays, cost overruns, and regulatory changes** must be stress-tested.

✔ Banks must evaluate **economic downturns, policy changes, and demand fluctuations**.

📢 **Example:**

✅ **NHAI Highway Project**: Delayed but banks **secured funding via phased disbursement**.

❌ **IL&FS Crisis (2018)**: Poor risk assessment led to **default of ₹91,000 crores** in infrastructure loans.

Equity Capital Verification 🔎

Why is RBI cautious?

✔ **Multiple leveraging** distorts **Debt-to-Equity (D/E) Ratios**.

✔ Borrowers may **inflate financial strength** by **infusing debt as equity**.

📢 **Example:**

❌ **DHFL (Dewan Housing Finance Ltd.)** fraud: Promoters used **fake equity capital** to secure large bank loans.

Director Identification & PAN Check 🛡

✔ **All directors must be verified through DIN/ PAN** before loan approvals.

✔ Prevents **wilful defaulters from securing fresh loans**.

📢 **Example:**

❌ **Vijay Mallya (Kingfisher Airlines)** secured loans using **multiple shell companies**.

✅ **Now, RBI mandates DIN/PAN verification for all loan applicants.**

End-Use Monitoring of Funds 💰

✔ Banks must conduct **independent audits** to track **fund utilization**.

✔ If funds are **diverted**, strict **recovery actions** must be taken.

📢 **Example:**

❌ **Yes Bank Scam (2020):** ₹30,000 crore loaned to firms that **diverted funds for personal use**.

📌 **RBI Mandates:**

✅ Loan agreements must include **strict fund utilization clauses**.

✅ Banks **should hire external auditors** for fund tracking.

Strengthening Board Oversight 🏛

✔ **Proactive monitoring of NPAs and stressed assets.**

✔ Timely **classification of wilful defaulters & non-cooperative borrowers**.

📌 **CRILC (Central Repository of Information on Large Credits)**

🔷 Banks must **report loan data to CRILC for real-time monitoring**.

📢 **Example:**

✅ **HDFC Bank** has **strong governance policies**, leading to **low default rates**.

❌ **PMC Bank (2019)** failed due to **lack of board oversight on risky loans**.

Summary: RBI's Action Plan 🏦🚀

Action Area	RBI's Directive	Impact
Loan Appraisal	Independent assessment, no reliance on third-party reports.	Lower bad loans.
Infrastructure Loans	Sensitivity analysis & stress tests required.	Safer long-term investments.
Equity Capital Check	No debt infusion as equity.	Transparent financial reporting.
Director Verification	Mandatory DIN/PAN checks.	Prevent fraud and duplicate loans.
Fund Utilization Monitoring	External audits & end-use tracking.	Reduce fund diversion.
Board Oversight	CRILC reporting & wilful defaulter classification.	Strengthen governance & risk controls.

📌 Credit Information System in India 🏦📊

Introduction to Credit Information System 🔎

✔ The **Credit Information System** plays a crucial role in **credit risk management** by providing a **centralized database** of borrower information.

✔ It helps banks & financial institutions **assess creditworthiness, reduce NPAs, and prevent fraudulent lending**.

✔ **Key Components:**

- **Credit Information Companies (CICs)**
- **Central Repository of Information on Large Credits (CRILC)**

Credit Information Companies (CICs) 🏦

✔ The **need for Credit Information Bureaus** was recognized in 1999 by an RBI-formed **Working Group (Chairman: N.H. Siddiqui)**.

✔ As a result, **Credit Information Bureau (India) Ltd. (CIBIL)** was established in 2001.

✔ Later, **3 more CICs** were permitted to operate in India.

📌 List of RBI-Accredited Credit Information Companies in India (CICs)

Type	Company Name
Domestic	🔷 TransUnion CIBIL Ltd.

	🔹 Equifax Credit Information Services Pvt. Ltd.
	🔹 Experian Credit Information Company of India Pvt. Ltd.
	🔹 CRIF High Mark Credit Information Services Pvt. Ltd.
International	🔹 Fitch Ratings
	🔹 Moody’s
	🔹 Standard & Poor’s

📢

✔ Every credit institution **must become a member of at least one CIC**.

✔ **Mandatory data submission:** CICs must collect **borrower data monthly or at shorter intervals**.

✔ **Fee structure:**

- One-time **membership fee: ₹10,000 per CIC**
- Annual **membership fee: ₹5,000 per CIC**

📢 **Example:** ✅ **CIBIL Score (300-900)** helps banks evaluate a borrower’s creditworthiness before approving a loan.

Central Repository of Information on Large Credits (CRILC) 📊

✔ **CRILC** was launched by **RBI to track large-value credit exposures (₹5 Crore & above)**.

✔ It enables **real-time monitoring of high-value loans** to prevent defaults and NPAs.

✔ Banks are required to **report credit data, including Special Mention Accounts (SMA)** classifications.

📌 Key CRILC Reporting Requirements

Criteria	Requirement
Minimum Loan Exposure	₹5 Crore (fund-based & non-fund-based)
Exemptions	Crop Loans
Reporting of Special Mention Accounts (SMA)	Mandatory
Interbank Exposures	Not Reported
Current Account Balances	₹1 Crore & above to be reported

📢 **Example:**

✅ If a company defaults on a **₹100 crore loan**, **all banks in CRILC** will be alerted in real-time.

Impact of Credit Information System 📊

✔ **Better Risk Assessment** → Banks can avoid lending to **high-risk borrowers**.

✔ **Faster Loan Approvals** → Low-risk borrowers get **quick approvals** based on their credit scores.

✔ **Lower NPAs** → Early warning systems (CRILC) **prevent defaults**.

✔ **Fraud Prevention** → **Wilful defaulters list** prevents fraudulent loan applications.

📌 **Example of a Failure Due to Poor Credit Monitoring**

❌ **IL&FS (Infrastructure Leasing & Financial Services) Crisis (2018)**

- IL&FS **took huge loans** but **defaulted** due to poor financial discipline.
- Lack of **real-time reporting** resulted in **₹91,000 Crore default**, triggering a financial crisis.

Summary of Credit Information System 🏦🚀

Component	Purpose	RBI Guidelines
Credit Information Companies (CICs)	Track borrower credit history	Every credit institution must be a member of all CICs
CIBIL Score	Assess creditworthiness	Score Range: **300-900**
CRILC	Monitor large-value loans (₹5 Cr & above)	Mandatory reporting of NPAs & SMAs
Wilful Defaulter List	Track fraudulent borrowers	Banks must report **₹25 Lakh+ defaulters** monthly