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Isda poised to issue India netting opinion

Dealers say ability to apply close-out netting for capital calculations will boost derivatives market



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The International Swaps and Derivatives Association is set to recognise India as an effective netting jurisdiction in a positive legal opinion due to be published “imminently” for its members. Dealers say clarity on the enforceability of close-out netting in the country will free up large amounts of regulatory capital that banks are currently required to set aside for derivatives transactions, allowing them to do more trades.

“If you look at the Indian private sector banks or the foreign banks that are active on derivatives, there should be a meaningful regulatory capital benefit,” says Amlan Chaudhuri, a member of JP Morgan’s fixed income team and head of the bank’s institutional sales for India. “And if you can allocate capital more efficiently, it will only serve to aid business.”

The finalising of a legal opinion, which is being drafted by Isda’s legal counsel Juris Corp in Mumbai, comes after the Reserve Bank of India (RBI) published a notice in March that amended certain prudential guidelines in order to recognise netting for exposure and capital calculations.

Earlier that month, the central bank published another notification defining the so-called qualified financial contracts (QFCs) to which close-out netting will apply. The notification identified two classes of transaction: derivatives and repurchase agreements.

The Bilateral Netting of Qualified Financial Contracts Act 2020 was [introduced in Lok Sabha](#), the lower house of India's parliament, in September last year. The law created a legislative framework that permits close-out netting on QFCs where one party is a regulated entity in India.

When banks can use close-out netting, positive and negative mark-to-market amounts can be collapsed into a single amount payable upon default. Although banks in India can apply the technique when calculating counterparty risk exposures, a framework was required for them to use it for regulatory capital calculations.

"A lot of banks in India were already using netting internally for credit – what we didn't have was the ability to net exposure from a regulatory capital calculation," says Chaudhuri. "That's what has changed because of this notification by the RBI. It allows you to net your exposure when calculating capital, so what banks have to put aside in terms of capital will come down."

Two-part approach

The legal opinion will be structured into two sections, according to lawyers from Juris Corp. One part will set out where close-out netting can be applied.

"The condition of the netting act is you need to be dealing only QFCs and one of the counterparties is a regulated entity in India," says Jayesh H, co-founder of Juris Corp in Mumbai. "That's the first part of the legal opinion and it assumes these two conditions are being satisfied."

The second part of the opinion will address the circumstances in which close-out netting cannot be applied by market participants. One such instance would be a transaction using an instrument that is not a QFC. Another would be if neither counterparty is a regulated entity in India.

Due to an absence of onshore commodity dealers, Indian companies typically go offshore to hedge commodity exposures. While close-out netting may not be applied under the netting act in these circumstances, because neither party is a regulated entity in India, it will still get enforced as the principle of mutual dealing and set-off is applicable in the insolvency of an Indian company, says H.

He adds that although the drafting of the legal opinion is close to completion and its publication is imminent, the full impact may take some time to materialise: “Once that opinion gets issued, [banks] will need to digest it. And some of the global banks, at least, need their netting committee approval to fall into place, which can take a bit of time. Even outside of that, for the banks to redo their systems [to take into account] the manner of regulatory capital computation – I don’t think this will happen overnight.”

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