



INTERNATIONAL FINANCE

Credit default swaps

A contract that transfers the risk of a borrower defaulting, for a fee, and what India now allows

Rules as on 16 October 2026

For training and education only. Not investment advice.

A credit default swap moves the risk that a borrower fails to pay from one party to another, for a price.

The borrower is not part of the deal. Two other parties agree: one pays a regular fee, the other promises to pay up if the borrower defaults.

Four words to know first



Protection buyer

Pays a regular fee; gets paid if the borrower defaults. Often holds the borrower's bonds, but not always.



Protection seller

Takes the fee and the risk. Must pay the buyer if the borrower defaults. Takes on the credit risk for income.



Reference entity

The borrower whose default is covered. Its debt, such as a bond, is the 'reference obligation'. Not a party to the swap.



Credit event

The trigger: typically the borrower failing to pay, going bankrupt or restructuring its debt. It sets off the payout.

The fee is the CDS premium, quoted per year as a percentage (or in basis points) of the amount covered.

Source: RBI (Credit Derivatives) Directions, 2026, definitions in paragraph 2.

The fee and the payout, with arithmetic

THE SET-UP

A lender holds ₹10 crore of one company's bonds.

It buys CDS protection on that ₹10 crore. The agreed premium is 2% a year (200 basis points).

- 1 Premium: 2% of ₹10 crore = ₹20 lakh a year, paid by the buyer to the seller while the contract runs.
- 2 No default: the seller pays nothing. Over two years the buyer has paid ₹40 lakh for the cover and still holds its bonds.
- 3 Default happens: say the bonds are then worth 40% of face value. The loss is 60% of ₹10 crore = ₹6 crore.
- 4 The seller pays that ₹6 crore to the buyer and the premiums stop. The buyer's loss on the bonds is made good.

The buyer swapped an uncertain big loss for a known yearly fee; the seller took on that risk.

Illustration with assumed, round figures. Recovery rates vary and are not known in advance.

How a single-name CDS works

1

Agree the terms

The two parties fix the reference entity, the amount covered, the premium, the maturity and what counts as a credit event.

2

Pay the premium

The buyer pays the premium at set dates. This continues until the contract matures or a credit event occurs, whichever comes first.

3

A committee decides

If a default is claimed, a Credit Derivatives Determinations Committee set up by FIMMDA decides whether a credit event has in fact occurred.

4

Settle, or run to maturity

On a credit event the seller pays the buyer and the contract ends. With no credit event, it simply ends at maturity.

Source: RBI (Credit Derivatives) Directions, 2026, paragraphs 4 and 5.

What Indian rules now allow

The RBI (Credit Derivatives) Directions, 2026 widened the products beyond plain CDS.

Product	What it is	Where traded
Single-name CDS	Protection against the default of one named borrower.	OTC and exchange
Index CDS	Protection on a basket of borrowers tracked by a credit index.	OTC and exchange
Total return swap	Swaps the full return of a bond (income plus price change) for a set payment.	OTC only
Credit index futures	A standardised, exchange-traded futures contract on a credit index.	Exchange

Source: RBI (Credit Derivatives) Directions, 2026, paragraphs 4 and 6.

How a debt mutual fund may use CDS

SEBI set the conditions for mutual funds in a circular dated 20 September 2024.



Buying protection

A scheme may buy CDS only to hedge the credit risk of debt securities it already holds. The CDS cannot cover more than that holding, and must be closed within 15 working days if the bond is sold.



Selling protection

A scheme may also sell CDS, backed by cash, government securities or Treasury bills set aside as cover. Overnight and liquid schemes may not sell CDS.

Before this circular, a fund could only buy CDS, and only in fixed maturity plans of over one year.

Source: SEBI Master Circular for Mutual Funds, 20 Mar 2026, para 13.17.

Where things stand

Regulatory position as on 16 October 2026. These are rules, not market prices.

CURRENT RULEBOOK

2026

RBI Directions 2026: in force 25 Jun 2026, replacing the 2022 ones.

OTC REPORTING

30 min

A market-maker must report each OTC trade to CCIL within 30 minutes.

FPI SELL CAP

5%

All FPIs' protection sold is capped at 5% of corporate bonds outstanding.

WHO MAY SELL

5

Sellers: only insurers, pension funds, mutual funds, AIFs and FPIs.

Sources: RBI (Credit Derivatives) Directions, 2026, paragraphs 1, 4 and 5.

If you learnt this from older material

Older explanations of CDS often pre-date India's current rules.

What older material says

- A CDS is an overseas idea, explained with two friends lending money.
- No Indian rulebook is mentioned; it is for banks abroad.
- Only plain, single-name CDS exists.

What holds now

- RBI rules since 2011-13; replaced in 2022, then by the 2026 directions.
- RBI sets who may trade, the products and the reporting.
- Mutual funds, insurers and others may take part; more products are allowed.

The idea is old; the Indian market and its rulebook are recent and still developing.

Sources: RBI (Credit Derivatives) Directions, 2022 and 2026; SEBI circular of 20 September 2024.

Four things people get wrong



'A CDS is the same as insurance.'

It works like insurance, but is a derivative under RBI rules, not an insurance policy. Retail users and mutual funds may buy only to hedge.



'The premium is the most I can lose.'

For the buyer, the contract cost is the premium, plus the risk the seller cannot pay. The seller can owe a payout far above the premium received.



'CDS pays out if the bond price falls.'

No. It pays only on a defined credit event, such as a default, not on day-to-day price moves.



'Only banks can use CDS in India.'

Banks are the main dealers, but mutual funds, insurers, pension funds, AIFs and FPIs may also take part, within limits.

Check yourself

Q1 Name the two parties to a credit default swap and say which one pays a regular fee.

Q2 A buyer pays 2% a year on ₹20 crore of protection. How much is the yearly premium, and when does the seller have to pay?

Q3 Under SEBI's rules, when may a debt mutual fund scheme buy a CDS?

Sources and disclaimer

SOURCES FOR THE FIGURES IN THIS DECK

- CDS and credit event definitions, products, participants, 30-min CCIL reporting, FPI 5% cap, Determinations Committee: RBI (Credit Derivatives) Directions, 2026 (in force 25 Jun 2026).
- Earlier framework permitting single-name CDS: RBI (Credit Derivatives) Directions, 2022 (in force 9 May 2022), superseded by the 2026 directions.
- MF CDS rules (buy only to hedge; sell with cover, investment-grade, 10% cap; 15-working-day unwind): SEBI/HO/IMD/PoD2/P/CIR/2024/125, 20 Sep 2024; Master Circular 20 Mar 2026, 13.17.
- The credit-event wording (failure to pay, bankruptcy, restructuring) sits in the standard master agreement, e.g. ISDA's 2023 Indian-credits template (2014 ISDA definitions).
- All rupee amounts, the 2% premium and the 40% recovery rate in the worked example are invented for illustration and are not market figures.

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