RBI/2013-14/406
DBOD.No.BP.BC.76/21.04.157/2013-14 December 9, 2013

All Scheduled Commercial Banks
(Excluding RRBs and LABs) &
All India Term-Lending & Refinancing Institutions

Madam / Sir,

Novation of OTC Derivative Contracts

Please refer to our circulars DBOD.No.BP.BC.86/21.04.157/2006-07 dated April 20, 2007 on Comprehensive Guidelines on Derivatives and DBOD.No.BP.BC.44/21.04.157/2011-12 dated November 2, 2011 on Comprehensive Guidelines on Derivatives: Modifications permitting novation of OTC derivative contracts. In view of the references received from banks, operational guidance on novation is enclosed.

Yours faithfully,

(Chandan Sinha)
Principal Chief General Manager

Department of Banking Operations and Development, Central Office, 12th Floor, Central Office Building, Shahid Bhagat Singh Marg, Mumbai - 400 001
बैंकिंग परिचालन और विकास विभाग, केंद्रीय कार्यालय, 12वीं मंज़िल, भारतीय रिजर्व बैंक, केंद्रीय कार्यालय भवन, शहीद भगत सिंह मार्ग, मुंबई – 400 001
Tel No: 022-2266 1602 /Fax No: 022-2270 5691 Email ID: cgmicdbodco@rbi.org.in

Novation of OTC Derivative Contracts

1. Novation

A novation is the replacement of a contract between two counterparties (Transferor[1], who steps out of the existing deal, and Remaining Party[2]) to an OTC derivatives transaction with a new contract between Remaining Party and a third party (Transferee[3]). Transferee becomes the new counterparty to Remaining Party. The novation can only be done with the prior consent[4] of Remaining Party.

2. Purpose of Novation

Novation may be used for management of counter-party exposure and counter-party credit risk, to deal with events such as winding-up of business/lines of business by banks and mergers/acquisitions.

3. Mechanism for Novation

3.1 Under novation, a tripartite agreement is signed between the three parties - Transferor, Remaining Party and Transferee, wherein, Transferee steps in the contract to face Remaining Party and Transferor steps out. The original contract stands extinguished and is replaced by a new contract with identical terms/parameters such as notional amount, maturity date, etc. to the original contract except for the change in counterparty for the Remaining Party.

3.2 Transferor and Remaining Party are each released from their obligations under the original transaction to each other and their respective rights against each other are

[1] a party to a transaction that proposes to transfer, or has transferred, by novation to a transferee all its rights, liabilities, duties and obligations with respect to a remaining party and discharges such remaining party.

[2] a party to a transaction whose consent is required in connection with, or who has consented to, a transferor's transfer by novation and the acceptance thereof by the transferee of all of the transferor's rights, liabilities, duties and obligations with respect to such remaining party.

[3] a party to a transaction that proposes to accept, or has accepted, a transferor's transfer by novation all of the rights, liabilities, duties and obligations of a transferor with respect to a remaining party.

[4] The remaining party would have full discretion and may reject the proposed novation. Such rejection can be on account of credit, operational, accounting or other reasons.

cancelled. These rights and obligations identical in their terms to original transaction are reinstated in the new transaction between Remaining Party and Transferee.

3.3 The novation should result in transfer of counterparty credit risk and market risk arising from the derivative contract from Transferor to Transferee.

3.4 Under the novation transaction, the amount corresponding to Mark-to-Market value of the derivative contract at the prevailing market rate on novation date should be exchanged between Transferor and Transferee who are actually economically impacted by the transaction. This exchange[5] of MTM should be done upfront. There should be no cash-flows for Remaining Party on account of novation transaction.

3.5 Transferor and Transferee may agree on the charge/fee between them for the transfer of the trade. The fees and their settlement terms may not form part of the novation agreement since these arrangements do not affect the Remaining Party.

3.6 Any document, which could be related to original contract and underlying exposure, should be transferred from Transferor to Transferee as part of the novation agreement.

4. Documentation

The three parties involved may use the standard novation agreement for this purpose.

5. Other Conditions

5.1 Transferor bank can novate a derivative contract only after the contract has been held by Transferor in its books for a minimum period of

- six months for contracts with original maturity of up to one year, and
- nine months for contracts with original maturity of more than one year.

[5] The exact consideration paid may differ from the Mark- to- Market value on account of any balance sheet usage charges that transferee may wish to impose in order to have the derivative transaction on its books for the residual maturity.

However, this condition would not apply in cases where Transferor bank is winding-up the business or put under liquidation.

5.2 Transferee bank can undertake novation only if Remaining Party is its constituent borrower.

5.3 Transferee bank should carry out necessary due diligence independently as required under RBI circular DBOD.No.BP.BC.44/21.04.157/2011-12 dated November 2, 2011 on ‘Comprehensive Guidelines on Derivatives: Modifications’ and Master Circular on *‘Risk Management and Inter-Bank Dealings’* issued by Foreign Exchange Department.