



BANKING AND FINANCE

# RBI Issues Draft Circular on Counterparty Credit Risk and Potential Future Exposure

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## Introduction

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On 20 August 2025, the Reserve Bank of India (RBI) issued a draft circular inviting public comments on the subject “Counterparty Credit Risk: Add-on factors for computation of Potential Future Exposure – Revised Instructions.” The draft circular modifies the extant framework contained in paragraph 5.15.3 of the Master Circular DOR.CAP.REC.2/21.06.201/2025-26 dated April 1, 2025 on Basel III Capital Regulations. Comments have been invited until 10 September 2025 through the RBI’s Connect 2 Regulate portal or via email.

This development is a part of RBI’s ongoing efforts to harmonise domestic capital adequacy rules with international standards set by the Basel Committee on Banking Supervision (BCBS), while also responding to the evolving Indian derivatives markets.

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## Legal and Regulatory Background

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The Basel III framework, developed by the Basel Committee on Banking Supervision (BCBS) after the 2008 global financial crisis, aims to strengthen the regulation, supervision, and risk management of banks. A central component of Basel III is the treatment of Counterparty Credit Risk (CCR), which arises when a counterparty to a financial contract, such as a derivatives trade, defaults before final settlement. To ensure adequate capital coverage, banks are required to calculate Potential Future Exposure (PFE), an estimate of the possible increase in exposure due to market movements over the life of a derivative contract.

Under the Current Exposure Method (CEM), which has been used since Basel II and continues with adjustments under Basel III, banks compute PFE by applying “add-on factors” to the notional value of contracts, differentiated by asset class and residual maturity. In the Indian context, the Reserve Bank of India (RBI) has transposed Basel III norms through circulars and master directions issued under its statutory powers derived from Section 35A of the Banking Regulation Act, 1949, and the Reserve Bank of India Act, 1934, which grant it authority over banking stability and regulation. The Master Circular on Basel III Capital Regulations operationalises these capital adequacy requirements for Indian banks, with paragraph 5.15.3 of the April 2025 circular specifically governing the computation of CCR under the CEM.

## Key Features of the Draft Circular (August 2025)

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- Clarification on Clearing Members:** Banks acting as clearing members of SEBI-recognised stock exchanges in the equity derivatives and commodity derivatives segments will now be explicitly required to maintain capital charges for CCR. This ensures uniform treatment of clearing exposures, aligning with global practice where clearing activities are recognised as generating CCR.
- Revision of Add-On Factors for PFE:** The draft circular proposes a revision of the add-on factors prescribed under the Current Exposure Method (CEM) for **Interest Rate Contracts** as well as **Exchange Rate Contracts and Gold**. These factors are being updated and largely aligned with the guidelines of the Basel Committee on Banking Supervision (BCBS). The existing add-on factors, which date back to **August 2008**, no longer fully capture the realities of today’s markets. Since then, India’s financial markets, particularly in interest rate and foreign exchange segments have expanded and deepened significantly. The revised factors are therefore intended to better reflect prevailing risk sensitivities and market conditions, ensuring more accurate measurement of potential exposures.
- Consultative Process:** RBI has opened the draft for public consultation until 10 September 2025, inviting feedback from banks, market participants, and other stakeholders. Submissions may be made through the Connect 2 Regulate portal on the RBI’s website or via email, with the subject line clearly referencing the draft on Counterparty Credit Risk and Potential Future Exposure. This consultative approach reflects RBI’s commitment to participatory regulation and provides the industry with an opportunity to highlight operational challenges, suggest refinements, and ensure smoother implementation of the revised

## Implications for Banks and Market Participants

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- **Increased Capital Requirements**

Banks engaged in derivatives clearing, particularly as clearing members of SEBI-recognised exchanges, may be required to hold additional capital against counterparty credit exposures. While this may affect short-term profitability, it is intended to enhance the overall resilience and stability of the banking system.

- **Alignment with International Practice**

By bringing the framework in line with Basel Committee on Banking Supervision (BCBS) guidelines, Indian banks will maintain credibility and competitiveness in cross-border dealings. This alignment also reduces the scope for regulatory arbitrage, creating consistency in the treatment of counterparty risk across global jurisdictions.

- **Enhanced Risk Sensitivity**

The revised add-on factors will improve the accuracy and sensitivity of risk measurement. These factors reflect the growing complexity and depth of India's interest rate and foreign exchange markets, ensuring that capital adequacy calculations capture potential exposures more effectively.

- **Compliance and Systems Update**

Banks will need to adapt their compliance frameworks and internal systems to accommodate the revised methodology. This will require recalibration of risk models, updating reporting structures, and adjusting capital planning mechanisms once the new rules are finalised and implemented.

## Conclusion

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The RBI's draft circular on Counterparty Credit Risk: Add-on factors for computation of Potential Future Exposure marks a significant regulatory update in the prudential capital framework. By clarifying obligations of clearing banks and revising add-on factors to align with Basel III standards, the RBI is signalling its commitment to maintaining financial stability, ensuring consistency with international norms, and addressing risks from India's growing derivatives markets.

Banks and market participants should closely evaluate the draft, assess the capital impact, and provide feedback within the consultation window. Once implemented, these changes will form a critical component of the Basel III capital adequacy framework in India, strengthening the resilience of the banking sector against counterparty risks.

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