

Draft Guidelines on Prudential Norms for Off-balance Sheet Exposures of Banks – Capital Adequacy, Exposure, Asset Classification and Provisioning Norms

At present, paragraphs 2.4.3 and 2.4.4 of the 'Master Circular on Prudential Norms on Capital Adequacy', DBOD.No.BP.BC.4/21.01.002/2007-08 dated July 2, 2007, stipulate the applicable credit conversion factors (CCF) for the foreign exchange and interest-rate related contracts under Basel-I framework. Likewise, paragraph 5.15.4 of our circular on 'Guidelines for Implementation of the New Capital Adequacy Framework' DBOD.No.BP.BC. 90/20.06.0001/2006-07 dated April 27, 2007, prescribes the CCFs for these contracts under the Basel-II framework. Further, in terms of paragraph 2.3.2 of the 'Master Circular on Exposure Norms', DBOD.No.Dir.BC.11/ 13.03.000/2007-08 dated July 2, 2007, the banks have the option of measuring the credit exposure of derivative products either through the 'Original Exposure Method' or 'Current Exposure Method'.

2. In accordance with the proposal contained in the paragraph 165 (reproduced in **Annex 1**) of the Annual Policy Statement for the year 2008-09, released on April 29, 2008, it is **proposed to effect the following modifications** to the existing instructions on the above aspects:

2.1 Credit Exposure – Method of computing the credit exposure

For the purpose of exposure norms, banks shall compute their credit exposures, arising on account of the interest rate & foreign exchange derivative transactions and gold, using the 'Current Exposure Method', as detailed in **Annex 2**.

2.2 Capital Adequacy – Computation of the credit equivalent amount

For the purpose of capital adequacy also, all banks, both under Basel-I as well as under Basel-II framework, shall use the 'Current Exposure Method', as detailed in **Annex 2**, to compute the credit equivalent amount of the interest rate & foreign exchange derivative transactions and gold.

2.3 Provisioning requirements for derivative exposures

Credit exposures computed as per the 'current exposure method', arising on account of the interest rate & foreign exchange derivative transactions, and gold, shall also attract provisioning requirement as applicable to the loan assets in the 'standard' category, of the concerned counterparties. All conditions applicable for treatment of the provisions for standard assets would also apply to the aforesaid provisions for derivative and gold exposures.

2.4 Asset Classification of the receivables under the derivatives transactions

It is reiterated that, in respect of derivative transactions, any amount receivable by the bank, which remains unpaid for a period of 90 days from the specified due date for payment, will be classified as non-performing assets as per the 'Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to the Advances Portfolio', contained in our Master Circular DBOD. No. BP.BC.12/ 21.04.048/2007-08 dated July 2, 2007.

2.5 Cash settlement of derivatives contracts

Any restructuring of the derivatives contracts, including the foreign exchange contracts, shall be carried out only on cash settlement basis.

3. The foregoing modifications will come into effect from the financial year 2008-09. The banks will, however, have the option of complying with the additional capital and provisioning requirements, arising from these modifications, in a phased manner, over a period of four quarters, ending March 31, 2009.

**Extracts of paragraph 165 from the
Annual Policy Statement for the year 2008 - 09**

b) Off-Balance Sheet Exposures of Banks

165. The Reserve Bank has, in the light of domestic developments, taken steps to strengthen the prudential framework in respect of on-balance sheet exposures of banks. Such measures included additional risk weights and provisioning requirements for exposures to specific sectors. In view of the recent developments in the global financial markets and drawing from suggestions for ensuring financial stability, it is proposed:

- to review current stipulations regarding conversion factors, risk weights and provisioning requirements for specific off-balance sheet exposures of banks and prescribe prudential requirements as appropriate. The guidelines in this regard would be placed on the Reserve Bank's website by May 15, 2008.

Para 5.15.4 of the RBI circular DBOD.No.BP.BC.90/20.06.001/2006-07 dated April 27, 2007 on the New Capital Adequacy Framework may be substituted by the following text:

“5.15.4 Current Exposure Method

i) The credit equivalent amount of a market related off-balance sheet transaction calculated using the current exposure method is the sum of current credit exposure and potential future credit exposure of these contracts.

ii) Current credit exposure is defined as the sum of the positive mark-to-market value of these contracts. The Current Exposure Method requires periodical calculation of the current credit exposure by marking these contracts to market, thus capturing the current credit exposure.

iii) Potential future credit exposure is determined by multiplying the notional principal amount of each of these contracts irrespective of whether the contract has a zero, positive or negative mark-to-market value by the relevant add-on factor indicated below according to the nature and residual maturity of the instrument.

Table 9 : CCF for market related off-balance sheet items

Residual Maturity	Credit Conversion Factor	
	Interest rate contracts	Exchange rate contracts & Gold
One year or less	0.50%	2.00%
Over one year to five years	1.00%	10.00%
Over five years	3.00%	15.00%

iv) For contracts with multiple exchanges of principal, the add-on factors are to be multiplied by the number of remaining payments in the contract.

v) For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be set equal to the time until the next reset date. However, in the case of interest rate contracts which have residual maturities of more than one year and meet the foregoing criteria, the CCF or “add-on factor” applicable shall be subject to a floor of 1.00 per cent.

vi) No potential future credit exposure would be calculated for single currency floating/floating interest rate swaps; the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

vii) Potential future exposures should be based on effective rather than apparent notional amounts. In the event that the stated notional amount is leveraged or enhanced by the structure of the transaction, banks must use the effective notional amount when determining potential future exposure. For example, a stated notional amount of USD 1 million with payments based on an internal rate of two times the BPLR would have an effective notional amount of USD 2 million. “