Credit Information Review

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Forward Rate Agreements/Interest Rate Swaps

The Reserve Bank of India allowed scheduled commercial banks (excluding Regional Rural Banks), primary dealers and all-India financial institutions to undertake Forward Rate Agreements/Interest Rate Swaps (FRAs/IRSs). The financial entities can undertake FRAs/IRSs as a product of their own balance sheet management and for market making purposes. These financial entities can also offer FRAs/IRS to corporates for hedging their (corporate) own balance sheet exposures.

The Reserve Bank has formulated guidelines on FRAs/IRSs in consultation with the participants and has advised them that before undertaking market making activity, they should ensure that appropriate infrastructure and risk management systems are put in place. Participants should also set up sound internal control system providing a clear functional separation of trading, settlement, monitoring and control and accounting activities.

It may be recalled that the Governor's Statement of October 30, 1998 on 'Mid-Term Review of Monetary and Credit Policy for 1998-99' announced that the Reserve Bank of India has decided, in principle, to create an environment that would facilitate introduction of interest rate swaps. The decision was taken with a view to further deepening the money market as also to enable banks, primary dealers and all-India financial institutions to hedge interest rate risks.

Guidelines on FRAs/IRSs

A Forward Rate Agreement or an Interest Rate Swap provides a means for hedging the interest rate risk arising on account of lending or borrowings made at fixed/variable interest rates. To enable the market to use FRAs/IRSs and for smooth development of these products, certain guidelines for FRAs/IRSs have been formulated. These guidelines are intended to form the basis for development of Rupee derivative products such as FRAs/ IRSs in the country. The guidelines are, however, subject to review, on the basis of development of FRAs/IRSs market.

Definition : A Forward Rate Agreement (FRA) is a financial contract between two parties to exchange interest payments for a 'notional principal' amount on settlement date, for a specified period from start date to maturity date. Accordingly, the parties make the cash payments based on contract (fixed) and the settlement rate to one another on the settlement date. The settlement rate is the agreed benchmark /reference rate prevailing on the settlement date.

An Interest Rate Swap (IRS) is a financial contract between two parties exchanging or swapping a stream of interest payments for a 'notional principal' amount on multiple occasions during a specified period. Such contracts generally involve exchange of a 'fixed to floating' or 'floating to fixed' rates of interest.

Participants : Scheduled commercial banks (excluding Regional Rural Banks), primary dealers (PDs) and all-India financial institutions (FIs) are free to undertake FRAs/IRSs as a product for their own balance sheet management or for market making. Banks/FIs/PDs can also offer these products to corporates for hedging their (corporate) balance sheet exposures. No specific permission from the Reserve Bank would be required to undertake FRAs/IRSs. When they start undertaking such transactions, however, participants will be required to inform the Monetary Policy Department (MPD) of the Reserve Bank and abide by such reporting requirements as prescribed by the Reserve Bank from time to time.

Types of FRAs/IRSs : Banks/PDs/FIs can undertake different types of plain vanilla FRAs/IRs.

Benchmark rate : The parties are free to use any domestic money or debt market rate as the benchmark rate for entering into FRAs/IRSs, provided methodology of computing the rate is objective, transparent and mutually acceptable to counter parties.

Size : There is no restriction on the minimum or maximum size of `notional principal' amounts of FRAs/IRSs.

Tenor : There is no restriction on the minimum or maximum tenor of the FRAs/IRSs.

Capital adequacy : Banks, PDs and financial institutions are required to maintain capital as specified by the Reserve Bank for FRAs/IRSs.

Exposure limits : Banks, FIs and PDs have to arrive at the credit equivalent amount for the purposes of reckoning exposure to their counterparts. The exposure should be within the sub-limit to be fixed by the participants concerned, for FRAs/IRSs to corporates/ banks/FIs/PDs. In case of banks and FIs, the exposure on account of FRAs/IRSs together with other credit exposures should be within single/group borrower limits as prescribed by the Reserve Bank.

While dealing with corporates, banks/FIs/PDs should exercise due diligence to ensure that the corporates undertake FRAs/IRSs only for hedging their own rupee balance sheet exposures. Banks/FIs/PDs should obtain a certificate from the authorised signatory/signatories of corporate/s in this regard. The certificate should ensure that the transactions undertaken by the corporate are meant for hedging balance sheet exposures only, i.e., size and tenor of the transactions undertaken are not in excess of their underlying rupee exposures.

Swap position : Participants are allowed to undertake market making activity, which at times would involve dealing in the market without underlying exposure. To ensure that market makers do not overextend themselves, however, the market makers are required to place prudential limits on swap positions arising out of market making activity.

Asset liability management : Scheduled commercial banks should place various components of assets, liabilities and off-balance sheet positions (including FRAs, IRSs) in different time buckets and fix prudential limits on individual gaps as per the procedure laid down by the circular of the Reserve Bank of India on Asset Liability Management (ALM) system. The FRAs/IRSs undertaken by banks will have to be within the prudential limits for different time buckets, approved by boards/management committees of banks. After approval of respective boards, the prudential limits on swap positions will require vetting by the Reserve Bank. Participants who can employ more sophisticated methods such as, value at risk and potential credit exposure for setting up of limits on `swap positions' and exposure limits may do so and report the methods to the Reserve Bank.

Accounting and valuation : Transactions for hedging and market making purposes should be recorded separately. While transactions for market making purposes should be marked to market (at least at fortnightly intervals), those for hedging purposes could be accounted for on accrual basis. For valuation purposes, the respective boards should lay down an appropriate policy to reflect the fair value of the outstanding contracts.

Documentation : For the sake of uniformity and standardisation, participants could consider using International Swaps and Derivatives Association (ISDA) documentation, as suitably modified to comply with these guidelines for undertaking FRAs/IRSs transactions.

Internal control : Participants should provide for a clear functional separation of front and back offices relating to hedging and market making activities. Similarly, functional separation of trading, settlement, monitoring and control and accounting activities should also be provided. The deals should be subjected to concurrent audit and result should be intimated to top management of the institution regularly.

Reporting : Participants are required to report their FRAs/IRSs operations on a fortnightly basis to the Reserve Bank of India.

Interest Rate Surcharge on Import Finance

The Reserve Bank of India has now decided that apart from the existing categories of bank credit for import, the following two categories of bank credit for import will also be exempt from the levy of interest rate surcharge with immediate effect.

- Import of crude oil by private and joint sector refineries for actual use in their own refineries; and
- All bonafide imports against the credit under the Duty Entitlement Pass Book (DEPB) Scheme contained in the EXIM Policy 1997-2000.

Reconciliation of Nostro Accounts

The Reserve Bank of India has decided that as a one-time measure, public sector banks may, for reconciling nostro accounts, adopt the following netting procedure. Banks should, however, do this after an inspection of their books by the internal auditors and after getting the proposal placed before their respective boards.

In respect of the entries pertaining to the period up to March 31, 1996 and remaining unreconciled as on March 31, 2000 the credit entries in each nostro account may be netted against the debit entries in the respective mirror account. Likewise, the debit entries in each nostro account may be netted against the credit entries in the respective mirror account. The net debit or net credit position, as the case may be, in each nostro account may be computed after that. The accounts showing net debit position and the accounts showing net credit position may be aggregated separately, taking care not to set off the net debit position in an account with a net credit position in another account or vice versa. The net debit and net credit position should be reflected in the bank's accounts for the year 1999-2000 by transferring the aggregate net debit to profit and loss account and the aggregate net credit to sundry creditors account.

Banks which have already transferred unreconciled debits to profit and loss account should not write back the same amount to the respective account in order to carry out netting exercise as indicated above.

For unreconciled debit entries in the nostro and mirror accounts for the subsequent period, i.e., from April 1, 1996 onwards and outstanding for more than three years, the banks should make 100 per cent provision in the relevant accounting year.

Unreconciled credit entries in the nostro and mirror accounts for the period from April 1, 1996 onwards and outstanding for more than three years may be segregated and kept in an account like unclaimed deposit account.

Salient Features of Rs. 500 Notes

Old series

1. *Watermark*: Ashoka Pillar emblem is clearly seen in the white space on the left as a light and shade effect when held against light.
2. *Intaglio*: The legend `RESERVE BANK OF INDIA', `500' printed in the centre of the note, the promise clause in Hindi and English, Ashoka Pillar emblem, Mahatma Gandhi portrait, language panel, five small black lines on the left side of the note are in raised printing. A blind person can even check these identification marks by touch.
3. *Number panel*: Both the panels containing the serial number of the note are printed in fluorescent ink and glow when the note is held against an ultra violet lamp.
4. *Latent image*: There is a latent image of the numeral `500’ and the word ‘RBI’ in the horizontal green belt that is below the portrait of Mahatma Gandhi. The latent image of `500’ and `RBI’ can be seen respectively when the note is held horizontally and vertically at the eye level.
5. *Security thread*: The note contains the security thread on the left hand side of the note.

New series

Seen with naked eye

1. *Watermark*: Rs.500 denomination notes issued in Mahatma Gandhi series have the portrait of Mahatma Gandhi in the watermark.
2. *Security thread*: The security thread in the note is placed on the right hand side of the note and can be easily identified as a broken silver line; but if held against light, this

silver line can be seen as a continuous black line. The security thread contains the words "RBI" and "Yeejle" clearly written alternatively on it which can be seen only on the front side of the note.

3. *Intaglio*: The portrait of Mahatma Gandhi, numeral 500, RBI seal, an arch-like pattern which can be seen below the RBI legend between watermark and the portrait of the Mahatma Gandhi, guarantee and promise clauses, Ashoka Pillar which is placed on the bottom left side of the watermark, as also, the RBI Governor's signature - are all embossed on these notes. These can be felt by touch.
4. *For the blind*: The notes also have solid circle in black in raised printing in between the flower and the Ashoka Pillar emblem on the left side of the watermark. This is to help the visually impaired to identify the note by touch.

At close examination

1. *Latent image*: The note has a latent image of the numeral `500' in the green vertical band placed on the right side of the note. The latent image can be seen only when the note is held against light at the eye level.
2. *Hollow design*: The flower on the left hand side of the watermark window slightly above the Ashoka Pillar emblem has a hollow design in front with solid on the back. When note is held against light, the solid fits into the hollow perfectly.
3. *Number panels*: The number panels are printed in fluorescent ink; the notes also have optical fibres. Both can be seen when the notes are exposed to ultraviolet lamp.
4. *Microlettering*: Between the head of the Mahatma Gandhi portrait and the green panel, the notes have very fine line design. When seen through a magnifying glass, the design will actually show "RBI" and denominational value `500' written in very small letters.
5. *Watermark*: Watermark window contains criss-cross lines that can be seen through a magnifying glass.

   All notes have a unique crackle sound.

Banks and Equity of Finance Companies

The Reserve Bank of India has reiterated its earlier advice to all commercial banks that they should not participate in the equity of any financial services' venture without obtaining the prior specific approval of the Reserve Bank of India. The Reserve Bank has stated that even if such investments are within the ceiling prescribed under Section 19(2) of the Banking Regulation Act, 1949, the prior permission from the Reserve Bank would be necessary. As per section 19(2) of the Banking Regulation Act, no banking company can hold shares in any company, whether as pledgee, mortgagee or absolute owner, an amount exceeding 30 per cent of the paid up share capital of that company or 30 per cent of its own paid up share capital and reserves, whichever is less. The Reserve Bank had, in October 1991, advised all commercial banks that banks/subsidiaries of banks should obtain prior approval of the Reserve Bank before making portfolio investments in the equity of financial companies including stock exchanges, depositories, etc.

TDS on FD Interest

All commercial banks have been advised to instruct their branches to deduct tax at source (TDS) on interest payment on term deposits on accrual basis. Banks should also immediately remit the tax so deducted to the Central Government account. The Reserve Bank has further reiterated that not deducting tax at source on interest paid on accrual basis is a serious violation of tax deduction at source provisions and entails a penalty.

Gold Loans to Non-Customers

The Reserve Bank has advised the banks authorised to deal in gold to grant gold (metal) loans to the jewellery exporters who are the customers of other banks not authorised to deal in gold by accepting the standby letter of credit or bank guarantee issued by their bankers. Such loans, however, should be made subject to authorised bank's own norms for lending and to certain conditions.

Funds for Brackish Water Aquaculture

The Reserve Bank of India has advised all scheduled commercial banks that adequate financial assistance may be provided to farmers undertaking brackish water aquaculture activity.

Target under SGSY

The Reserve Bank of India has circulated the credit mobilisation targets fixed by the Government of India under the Swarnjayanti Gram Swarozgar Yojana (SGSY) for 1999-2000 among all scheduled commercial banks. The Reserve Bank has advised that the state level bankers' committees (SLBCs) should spread the statewise targets over the commercial banks, co-operative banks and regional rural banks. The SLBCs should also fix the targets of individual banks on the basis of acceptable parameters, such as, resources, number of rural/semi-urban branches, etc., so that each bank would be in a position to arrive at its corporate target. The Reserve Bank has also stated that it would strictly monitor the achievement of those targets.

Implementation of PMRY

Target for 1999-2000 : The Government of India has set the targets under the Prime Minister's Rozgar Yojana (PMRY) for each state/Union Territory for the programme year 1999-2000. To prevent bunching of applications at the end of the year, the Reserve Bank of India has advised the controlling offices/branches of all scheduled commercial banks to achieve quarterly progress targets as follows:

(in per cent)

Quarter	Sponsoring	Sanctions	Disbursement
1st	25	10	-
2nd	100	50	15
3rd	125	80	50
4th	-	100	80
1st(succeeding year)	-	-	100

Sponsoring of applications should be limited to 125 per cent of the target by the end of the third quarter, that is, by December 31,1999 after which only the cases rejected by banks may be replaced. The applications pending as on March 31, 1999 may be considered during the current programme year so that the same person does not have to apply again.

The Reserve Bank has advised all scheduled commercial banks to give priority to the cases recommended by District Industrial Centre (DIC) and pending with the banks at the end of the year for sanction/disbursement in the next financial year. As per the normal practice, District Industrial Centres (DICs) sponsor the applications to the banks. The banks then sanction the loan and at a later stage disburse the sanctioned loan.

The Reserve Bank has also asked bank branches not to return the pending cases on the ground of "already reached target".

Project cost : The banks had sought clarification from the Reserve Bank regarding its instructions on project cost for business sector, other sectors, and the ceiling on share of each partner in project cost of partnership concerns. The Reserve Bank of India has clarified that projects up to Rs. one lakh for business sector and projects up to Rs. two lakh for other than business activities are covered under the scheme.

If two or more eligible persons join together in a partnership, projects up to Rs. 10 lakh can be undertaken by the firm. The individual ceiling on the share of the project cost for each one of the partners will, however, be dependent on the nature of the activity undertaken by the firm, i.e., Rs. one lakh per partner for business sector and Rs. two lakh per partner for other activities.

Reconciliation of data : The Reserve Bank has reiterated its earlier advice to all commercial banks that they should advise the lead bank officers and branch managers to send the monthly progress reports to DICs without delay. Earlier, the Reserve Bank had advised banks to forward monthly progress report as well as cumulative monthly progress report under PMRY to DICs.

Reschedulement of loan : The Government of India has decided that the borrowers can be allowed to repay the loan before the repayment schedule fixed by the bank. In such cases, however, the repayment of PMRY loan may be rescheduled with a minimum period of three years at the discretion of the branch manager so that the borrower receives an early credit of subsidy and is able to avail of additional loan facilities if desired.

Subsidy utilisation certificate : All Indian scheduled commercial banks have been advised to submit the final subsidy utilisation certificates/ pending claims statement pertaining to programme year 1997-98 in the prescribed format latest by August 31,1999 as the disbursements pertaining to the programme year 1997-98 would have been completed by February 1,1999. No subsidy claim for 1997-98 would be entertained after the stipulated date.

Exchange Control

General Permission to Foreign Airlines

The Reserve Bank of India has granted general permission to foreign airline companies, which do not have a branch, office or other place of business in India, to carry on their normal commercial activity in India through their local agents. The authorised dealers can now allow local agents of foreign airline companies to remit net surplus of passage fare/freight collection in India provided the agents certify the two necessary conditions. The conditions to be certified are:

(i) The airline's flights should obtain the requisite permission from the Director General of Civil Aviation (DGCA) in the case of on-line operations;

(ii) A bilateral air service agreement should exist between the Government of India and Government of the country of incorporation of the foreign airline company concerned, in case of off-line operations.

Remittance of Funds by Resident Nominees

The Reserve Bank would now consider requests from resident nominees for remittance of funds abroad out of their share of repatriable deposits of deceased Non Resident Indian (NRI) for discharging the liabilities abroad of the deceased account holder or for similar other purposes, on merits of the case. Authorised dealers may refer such applications to the Reserve Bank together with relevant documents.

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