DBOD. No. BP. 1763/21.04.157/2005-06

June 28, 2006

Chairmen/Chief Executive Officers
All Commercial Banks
(excluding RRBs and LABs)

Dear Sir/Madam,

Discussion Paper on Derivative and Hedge Accounting by banks

An internal Group was constituted for formulating the guidelines to be issued to banks on derivative and hedge accounting aspects. The Group has submitted its proposals in this regard, which are largely based on the principles of IAS 39. As this is an evolving area and since it is necessary for banks to understand the full implications of the proposed framework it has been decided to initially issue the proposed accounting framework as a 'Discussion Paper' for comments and feedback from banks. The Discussion Paper will be available for comments for a period of six weeks. A copy of this letter and the attached 'Discussion Paper' has also been placed on the Reserve Bank's website (www.rbi.org.in) for wider dissemination.

2. You may please arrange to study the proposed framework for derivative and hedge accounting in your bank and furnish your comments. The feedback may please be forwarded to the undersigned at the following address or by email to kdamodaran@rbi.org.in and minalajain@rbi.org.in within a period of six weeks from the date of this letter :

Department of Banking Operations & Development
Reserve Bank of India,
12th Floor, Central Office Building,
Shahid Bhagat Singh Marg,
Mumbai – 400 001

3. Please acknowledge receipt.

Yours faithfully,

(Prashant Saran)
Chief General Manager-in-Charge

Discussion Paper on Derivative and Hedge Accounting by banks

Executive Summary

Objective

Derivatives have a significant role to play in shaping the overall risk profile of banks. The growing complexity, diversity and volume of derivative products have emphasised the urgent need for adoption of uniform principles for recognition, classification, measurement and disclosure of derivatives and their inherent risks in banks' books of accounts and financial statements. In the above background, the guidelines laying down the principles for accounting of derivatives, including hedge accounting, have been formulated based on the principles enunciated in IAS 39: "Financial Instruments : Recognition and Measurement", after taking into account the unique country-specific circumstances.

Permissible derivative instruments

At present, banks in India are permitted to undertake transactions in the following derivative instruments:

a) Interest rate derivatives – Interest Rate Swaps (IRS), Forward Agreements (FRAs), and Interest Rate Futures.
b) Foreign exchange derivatives – forwards, foreign currency swaps, foreign currency – Rupee swaps, cross currency options, and foreign currency - Rupee options.

Classification of derivatives

All derivative instruments will be classified as below :

(a) Upon initial recognition all derivatives for 90 days or lesser will be designated by a bank in a new category called 'Derivative through Profit and Loss' (DPL) unless they meet the hedge accounting criteria.

All derivatives for a period longer than 90 days shall be included in a new category called 'Derivative through Revaluation Account' (DRA).

(b) In respect of derivatives that are designated as hedging instruments and meet the hedge accounting criteria, banks should follow the prescribed accounting guidelines, if they are effective hedging instruments. If not, the derivatives shall be accounted as DPL or DRA as the case may be.

(c) If the fair value of a derivative, including a hedging instrument, cannot be reliably measured, it should be included in a new category 'Derivatives at Cost' (DAC).

Accounting for derivatives

Initial recognition

A derivative may be recognised at fair value as an asset or liability at the time of initial recognition. The fair value will include the transaction costs in the case of derivatives classified under DRA and DAC.

Gains and losses on valuation of derivatives

The gains and losses on subsequent measurement of derivatives shall be recognised as follows:

(a) A gain or loss on subsequent measurement of a derivative included under DPL shall be recognised in the Profit and Loss account.

(b) A gain or loss on subsequent measurement of a derivative included under DRA shall be recognised in a new account titled 'Unrealised Gain/ Loss on Derivatives' (UGD).

(c) A derivative which is included under DAC should be held in the books at cost until a fair value is reliably established or the derivative is closed out or the derivative matures. A gain or loss is recognized in profit or loss when the derivative is closed out or at maturity.

Income recognition

Fee received/paid in respect of derivatives included under DPL and which have a fair value may be taken to profit and loss account upfront. In the case of derivatives included under DRA or DAC, fee received/ paid may be amortised over the life of the derivative instrument.

Embedded derivatives

An embedded derivative shall be separated from the host contract and accounted for as a derivative if, and only if:

a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;

b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

c) The changes in value of the hybrid (combined) instrument is not reflected in profit and loss account.

If an embedded derivative is separated from the host contract, the host contract will be treated as a financial instrument, other wise it will be treated as held for trading asset.

Hedge accounting

Hedge accounting recognizes the offsetting effects on profit or loss of changes in the fair value of the hedging instrument and the changes in the fair value attributable to the hedged risk of the hedged item. Hedge accounting is permitted in certain circumstances, provided the hedging relationship is clearly defined, can be reliably measured and is actually effective.

Hedging relationships

Hedging relationships are of three types.

(a) Fair value hedge

(b) Cash flow hedge

(c) Hedge of a net investment in a foreign operation as defined in AS 11.

Accounting of fair value hedge

a) the gain or loss from remeasuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount (for a non-derivative hedging instrument) shall be recognised in profit or loss; and

b) the gain or loss on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognised in profit or loss. This applies if the hedged item is otherwise measured at cost. Recognition of the gain or loss attributable to the hedged risk in profit or loss applies if the hedged item is an available-for-sale financial asset.

Accounting of cash flow hedge

a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognised in 'Unrealised gain/ loss on Derivatives' (UGD); and

b) the ineffective portion of the gain or loss on the hedging instrument shall be recognised in profit or loss.

Accounting of net investment

Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment, shall be accounted for similar to cash flow hedges.

Discontinuing hedge accounting

Hedge accounting may be discontinued prospectively in any of the following circumstances :

a) The hedging instrument expires or is sold, terminated or exercised.
b) The hedge no longer meets the criteria for hedge accounting .
c) The forecast transaction is no longer expected to occur.
d) The bank revokes the hedge designation.
e) The hedged item is settled.

Accounting of unrealised gains / loss on derivatives

Credit balance in 'Unrealised gain/loss on Derivatives' should be included as a separate item under Schedule 5: 'Other Liabilities and Provisions'. Debit balance in 'Unrealised gain/loss on Derivatives' should be included as a separate item under Schedule 11: 'Other Assets'. Since a debit balance in 'Unrealised gain/loss on Derivatives' is in the nature of intangible assets, it shall be deducted from Tier I capital for capital adequacy purposes.

Balance Sheet Disclosures

Disclosures covering quantitative and qualitative aspects will be made in Notes on Accounts.

1 Introduction

1.1 Derivatives have a significant role to play in shaping the overall risk profile of banks since they are present on both sides of a derivative transaction viz. as a buyer and a seller. Derivatives include a wide assortment of financial contracts, including forwards, futures, swaps and options. In addition, some conventional products incorporate derivative characteristics, due to the presence of an embedded derivative. We do not have an accounting standard which lays down the principles for accounting of derivatives. Consequently, there is lack of uniformity in the accounting practices leading to likely distortion in the financial position of entities using derivatives. The growing complexity, diversity and volume of derivative products has emphasised the urgent need for adoption of uniform principles for recognition, classification, measurement and disclosure of derivatives and their inherent risks in banks' books of accounts and financial statements.

1.2 The Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI) is engaged in the process of considering issue of an Accounting Standard on "Financial Instruments : Recognition and Measurement", which will be corresponding to the International Accounting Standard 39 (IAS 39). The proposed Accounting Standard will address accounting of derivatives, among others. However, the formal introduction of the Accounting Standard for recognition and measurement of financial instruments in India by the ICAI is likely to take some time.

1.3 In the above background, the guidelines laying down the principles for accounting of derivatives, including hedge accounting, have been formulated based on the principles enunciated in IAS 39: "Financial Instruments : Recognition and Measurement", after taking into account the unique country-specific circumstances.

2 Definitions :

2.1 At present, banks in India are permitted to undertake transactions in the following derivative instruments:

a) Interest rate derivatives – Interest Rate Swaps (IRS), Forward Agreements (FRAs), and Interest Rate Futures.

b) Foreign exchange derivatives – forwards, foreign currency swaps, foreign currency – Rupee swaps, cross currency options, and foreign currency - Rupee options.

Banks should adopt the following guidelines while accounting the above derivatives in their books and comply with the related requirements, including disclosure requirements.

2.2 A **derivative** is a financial instrument which must meet all three of the following characteristics:

(a) its value changes in response to the change in a specified interest rate, financial instrument price, foreign exchange rate, index of any of the above prices or rates and any other underlying explicitly permitted by the Reserve Bank;

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and

(c) it is settled at a future date.

2.3 **Financial Instrument:** is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity of another enterprise.

2.4 **Financial Asset:** is any asset that is : (a) cash; (b) a contractual right to receive cash or another financial asset from another enterprise; (c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or (d) an equity instrument of another enterprise.

2.5 **Financial Liability:** is any liability that is a contractual obligation: (a) to deliver cash or another financial asset to another enterprise: or (b) to exchange financial instruments with another enterprise under conditions that are potentially unfavourable. Also, if a financial instrument that was previously recognized as a financial asset is measured at fair value and its fair value falls below zero, it becomes a financial liability.

2.6 **Fair Value:** Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. The underlying concept of fair value is the presumption that the bank is a going concern, and does not have an intention or need to liquidate to curtail materially the scale of its operations or to undertake a transaction on adverse terms. Therefore, fair value normally is not an amount that a bank would receive or pay in a forced transaction, involuntary liquidation or distress sale. The fair value of a derivative is the equivalent of the unrealized gain or loss from marking to market the derivative using prevailing market rates or internal valuation technique. The fair value of a derivative should be reliably measurable. Fair value may be obtained from various sources, such as:

- A published price quotation in an active market (current bid price for an asset and current asking price for a liability);

- In the absence of a current bid or asking price, by reference to prices available from most recent transactions as long as there has not been a significant change in economic circumstances since the time of the transaction; and

- In the absence of an active market, fair value is estimated on the basis of the results of a valuation technique that makes maximum use of market inputs, and relies as little as possible on entity-specific inputs. A valuation technique would be expected to arrive at a realistic estimate of the fair value if (a) it reasonably reflects how the market could be expected to price the instrument and (b) the inputs to the valuation technique reasonably represent market expectations and measures of the risk-return factors inherent in the financial instrument.

- The bank should periodically calibrate the valuation technique and test it for validity using prices from observable current market transactions in the same instrument, in the same market where the derivative instrument was originated or purchased.

The methods used to determine fair value should be consistently applied during and between reporting periods for similar types of instruments.

Definitions relating to Hedge accounting

2.7 A **firm commitment** is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

2.8 A **forecast transaction** is an uncommitted but anticipated future transaction.

2.9 A **hedging instrument** is

(a) a designated derivative; or

(b) in the case of hedging of the risk of changes in foreign currency exchange rates, a designated non-derivative financial asset or non-derivative financial liability; whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item**.**

2.10 A **hedged item** is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged.

2.11 **Hedge effectiveness** is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

3 Classification of derivatives

3.1 All derivative instruments will be classified as below.

(a) Upon initial recognition all derivatives for 90 days or lesser will be designated by a bank in a new category called ‘Derivative through Profit and Loss’ (DPL) unless they meet the hedge accounting criteria (c.f. paragraph no.7 & 8). A derivative for a period longer than 90 days shall be included in a new category called ‘Derivative through Revaluation Account’ (DRA). Banks should follow the applicable accounting guidelines prescribed below for DPL and DRA categories.

(b) In respect of derivatives that are designated as hedging instruments and meet the hedge accounting criteria, banks should follow the applicable accounting guidelines prescribed below (c.f. paragraph nos. 11, 12 and 13) if they are effective hedging instruments. If not, the derivatives shall be accounted as DPL or DRA as the case may be.

(c) If the fair value of a derivative, including a hedging instrument, cannot be reliably measured, it should be included in a new category ‘Derivatives at Cost’ (DAC).

4 Accounting for derivatives

4.1 Initial recognition

A derivative usually has a notional amount, which is an amount of currency, specified in the contract. However, a derivative instrument does not require the holder or writer to invest or receive the notional amount at the inception of the contract. Derivatives generally require no initial net investment. Hence a derivative may be recognised at fair value as an asset or liability at the time of initial recognition. The fair value will include the transaction costs in the case of derivatives classified under DRA and DAC.

4.2 Gains and losses on valuation of derivatives

The gains and losses on subsequent measurement of derivatives shall be recognised as follows:

(a) A gain or loss on subsequent measurement of a derivative included under DPL shall be recognised in the Profit and loss account.

(b) A gain or loss on subsequent measurement of a derivative included under DRA shall be recognised in a new account titled ‘Unrealised Gain/ Loss on Derivatives’ (UGD).

(c) A derivative which is included under DAC should be held in the books at cost until a fair value is reliably established or the derivative is closed out or the derivative matures. A gain or loss is recognized in profit or loss when the derivative is closed out or at maturity.

4.3 **Income recognition**

Fee received/paid in respect of derivatives included under DPL and which have a fair value may be taken to profit and loss account upfront. In the case of derivatives included under DRA or DAC, fee received/ paid may be amortised over the life of the derivative instrument.

4.4 **Embedded derivatives**

4.4.1 An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract —with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract. A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.

4.4.2 An embedded derivative shall be separated from the host contract and accounted for as a derivative if, and only if:

a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;

b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

c) The changes in value of the hybrid (combined) instrument is not reflected in profit and loss account.

4.4.3 If an embedded derivative is separated, the host contract shall be accounted for as a financial instrument.

4.4.4 Notwithstanding paragraph 4.4.2 above ,if a contract contains one or more embedded derivatives, a bank may designate the entire hybrid (combined)contract as a held for trading asset unless :

a) the embedded derivative(s)does not significantly modify the cash flows that otherwise would be required by the contract; or

b) it is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

4.4.5 If a bank is required to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately either at acquisition or at a subsequent financial reporting date, it shall designate the entire hybrid (combined) contract as held for trading asset.

4.4.6 If a bank is unable to determine reliably the fair value of an embedded derivative on the basis of its terms and conditions (for example, because the embedded derivative is based on an unquoted equity instrument), the fair value of the embedded derivative is the difference between the fair value of the hybrid (combined) instrument and the fair value of the host contract, if those can be determined. If the entity is unable to determine the fair value of the embedded derivative using even this method, the hybrid (combined) instrument is designated as held for trading asset.

5 **Hedge accounting**

5.1 Hedging refers to assumption of a position in a hedging instrument such that change in its value or cash flows significantly offsets any change in the value or cash flows of another designated asset or liability (hedged item).

5.2 Hedge accounting recognizes the offsetting effects on profit or loss of changes in the fair value of the hedging instrument and the changes in the fair value attributable to the hedged risk of the hedged item. Hedge accounting is permitted in certain circumstances, provided the hedging relationship is clearly defined, can be reliably measured and is actually effective.

5.3 The need for hedge accounting arises in part because derivatives are measured at fair value, whereas the items they hedge may be measured at cost or not recognised at all. Without hedge accounting, a bank might recognise volatility in profit or loss for matched positions.

6 **Hedging relationships**

Hedging relationships are of three types.

6.1 **Fair value hedge**: A hedge of the ***exposure to changes in fair value*** of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, ***that is attributable to a particular risk*** and could affect profit or loss.

6.2 **Cash flow hedge:** A hedge of the ***exposure to variability in cash flows that is attributable to a particular risk*** associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and could affect profit or loss.

6.3 **Hedge of a net investment in a foreign operation** will be as defined in AS 11.

A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.

7 Qualifications for hedge accounting

7.1 A hedging relationship qualifies for hedge accounting if, and only if, all of the following conditions are met:

7.1.1 The hedge must relate to a specific identified and designated risk, and not merely to the entity's general business risks, and must ultimately affect the bank's profit or loss.

7.1.2 At the inception of the hedge there is **formal designation and documentation** of (i) the hedging relationship; (ii) the entity's risk management objective and (iii) strategy for undertaking the hedge. That documentation shall include identification of

- the hedging instrument,
- the hedged item or transaction,
- the nature of the risk being hedged, and
- how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.

7.1.3 The hedge is expected to be **highly effective in achieving offsetting changes** in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.

7.1.4 For cash flow hedges, a forecast transaction that is the subject of the hedge must be *highly probable* and must present an exposure to variations in cash flows that could ultimately affect profit or loss.

7.1.5 The term 'highly probable' indicates a much greater likelihood of happening than the term 'more likely than not'. An assessment of the likelihood that a forecast transaction will take place is not based solely on management's intentions because intentions are not verifiable. A transaction's probability should be supported by observable facts and the attendant circumstances. In assessing the likelihood that a transaction will occur, a bank should consider the following circumstances:

(i) the frequency of similar past transactions;

(ii) the financial and operational ability of the entity to carry out the transaction;

(iii) substantial commitments of resources to a particular activity (for example, a manufacturing facility that can be used in the short run only to process a particular type of commodity);

(iv) the extent of loss or disruption of operations that could result if the transaction does not occur;

(v) the likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, a bank that intends to raise cash may have several ways of doing so, ranging from a short-term borrowing to an offering of ordinary shares); and

(vi) the bank's business plan.

7.1.6 The **effectiveness** of the hedge **can be reliably measured**, i.e., the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured.

7.1.7 The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

7.2 A hedge of an overall net position (for example: the net of all fixed rate assets and fixed rate liabilities with similar maturities), rather than a specified hedged item, does **<u>not</u>** qualify for hedge accounting.

7.3 A hedge of the risk of obsolescence of a physical asset or the risk of expropriation of property by a government is **<u>not</u>** eligible for hedge accounting - effectiveness cannot be measured because those risks are not measurable reliably.

7.4 If the bank does not meet hedge effectiveness criteria mentioned at paragraph 8 below, the bank should discontinue hedge accounting from the last date on which compliance with hedge effectiveness was demonstrated. If the bank identifies the event or change in circumstances that caused the hedging relationship to fail the effectiveness criteria, and demonstrates that the hedge was effective before the event or change in circumstances occurred, the bank discontinues hedge accounting from the date of the event or change in circumstances.

8 Assessing hedge effectiveness

8.1 A hedge is regarded as highly effective, only if (a) and (b) are met:

a) At the inception of the hedge and in subsequent periods, the hedge is **expected** to be highly effective in achieving offsetting changes in fair value or cash flows of the hedged item attributable to the hedged risk during the period for which the hedge is designated. Such an expectation can be demonstrated

(i) by comparison of past changes in, or

(ii) by demonstrating a high correlation between the fair values or cash flows of the hedged item and the hedging instrument

b) The actual results of the hedge are within a range of 80 and 125 per cent.

For example, if actual results are such that the loss on the hedging instrument is Rs. 120 and the gain on the cash instrument is Rs. 100, offset can be measured by 120/100, which is 120 per cent, or by 100/120,which is 83 per cent. In this example, assuming the hedge meets the condition in (a), the bank would conclude that the hedge has been highly effective.

8.2 Effectiveness should be assessed, at a minimum, at the time a bank prepares its annual or interim financial statements and at quarterly intervals.

8.3 A bank must adopt a method for assessing hedge effectiveness that is consistently applied for similar types of hedges unless different methods are explicitly justified. The method chosen will depend on the entity's risk management strategy and shall be adopted consistently throughout the period of the hedge. The chosen methods shall be consistently applied across hedges of similar types during the entire accounting period.

8.4 In the case of interest rate risk, hedge effectiveness may be assessed by preparing a maturity schedule for financial assets and financial liabilities that shows the net interest rate exposure for each time period, provided that the net exposure is associated with a specific asset or liability (or a specific group of assets or liabilities or a specific portion of them) giving rise to the net exposure, and hedge effectiveness is assessed against that asset or liability.

8.5 In assessing the effectiveness of a hedge, a bank generally considers the time value of money. The fixed interest rate on a hedged item need not exactly match the fixed interest rate on a swap designated as a fair value hedge. Nor does the variable interest rate on an interest-bearing asset or liability need to be the same as the variable interest rate on a swap designated as a cash flow hedge. A swap's fair value derives from its net settlements. The fixed and variable rates on a swap can be changed without affecting the net settlement if both are changed by the same amount.

9 Qualifying hedging instruments

9.1 A derivative, which meets the conditions in paragraph 7 & 8 above, may be designated as hedging instrument. However, non-derivative financial asset or non-derivative financial liability may be designated as a hedging instrument only for hedge of a foreign currency risk.

9.2 Only instruments that involve a party external to the reporting entity (i.e., external to the group, segment or individual entity that is being reported on) can be designated as hedging instruments. However, they may qualify for hedge accounting in the individual or separate financial statements of individual entities within the group or in segment reporting provided they are external to the bank or segment that is being reported on.

9.3 There is normally a single fair value measure for a hedging instrument in its entirety, and the factors that cause changes in fair value are co-dependent. Thus, a hedging relationship is designated by a bank for a hedging instrument in its entirety.

9.4 The only exceptions permitted are:

(i) separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and excluding change in its time value; and

(ii) separating the interest element and the spot price of a forward contract.

These exceptions are permitted because the intrinsic value of the option and the premium on the forward can generally be measured separately. A dynamic hedging strategy that assesses both the intrinsic value and time value of an option contract can qualify for hedge accounting.

9.5 A proportion of the entire hedging instrument, such as 50 per cent of the notional amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding.

9.6 A single hedging instrument may be designated as a hedge of more than one type of risk provided that (i) the risks hedged can be identified clearly; (ii) the effectiveness of the hedge can be demonstrated; and (iii) it is possible to ensure that there is specific designation of the hedging instrument and different risk positions.

9.7 Two or more derivatives, or proportions of them (or, in the case of a hedge of currency risk, two or more non-derivatives or proportions of them, or a combination of derivatives and non-derivatives or proportions of them), may be viewed in combination and jointly designated as the hedging instrument, including when the risk(s) arising from some derivatives offset(s) those arising from others. Two or more instruments (or proportions of them) may be designated as the hedging instrument only if none of them is a written option or a net written option.

10 Qualifying hedged items

10.1 A hedged item can be (i) a **single** asset or liability, an unrecognized firm commitment, a highly probable forecast transaction that involve a party external to the entity or a net investment in a foreign operation; (ii) a **group** of assets or liabilities, firm commitments, highly probable forecast transactions that involve parties external to the entity or net investments in a foreign operations with similar risk characteristics; or (iii) in a portfolio hedge of interest rate risk only, a **portion of the portfolio** of financial assets or financial liabilities that share the risk being hedged.

10.2 A hedged item must create an exposure to risk that could affect the income statement, currently or in future periods. The usual types of risks that are hedged include interest rate risk and foreign currency risk. Some examples of exposures that can be hedged are :

(a) originated loans;
(b) fixed interest debt securities classified as AFS;
(c) deposits;
(d) borrowings;
(e) foreign currency monetary items.

10.3 A held-to-maturity investment cannot be a hedged item with respect to interest-rate risk or prepayment risk because designation of an investment as held to maturity requires an intention to hold the investment until maturity without regard to changes in the fair value or cash flows of such an investment attributable to changes in interest rates. However, a held-to-maturity investment can be a hedged item with respect to risks from changes in foreign currency exchange rates and credit risk.

10.4 Only assets, liabilities, firm commitments, or highly probable forecast transactions that involve a party external to the bank can be designated as a hedged item. However, they may qualify for hedge accounting in the individual or separate financial statements of individual entities within the group or in segment reporting provided they are external to the bank or segment that is being reported on and not in the consolidated financial statements.

10.5 If the hedged item is a financial asset or financial liability, it may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value provided that effectiveness can be measured.

10.6 Only in a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities, the portion hedged may be designated in terms of an amount of a currency rather than as individual asset or liability. Though the portfolio may include assets and liabilities, the amount designated is an amount of assets **or** an amount of liabilities. Designation of a net amount including assets **and** liabilities is not permitted. Further, the bank may hedge a portion of the interest rate risk associated with this designated amount.

10.7 If the hedged item is a non financial asset or non financial liability, it shall be designated as a hedged item (a) for foreign currency risks, or (b) in its entirety for all risks, because of the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to specific risks other than foreign currency risks.

10.8 Similar assets and similar liabilities shall be aggregated and hedged as a group only if the individual assets or individual liabilities in the group share the risk exposure that is designated as being hedged. Furthermore, the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items.

10.9 Since a bank is required to assess hedge effectiveness by comparing the change in the fair value or cash flow of a hedging instrument and a hedged item, comparing a hedging instrument with an overall net position (for example, the net of all fixed rate assets and all fixed rate liabilities with similar maturities), rather than with a specific hedged item, does **not** qualify for hedge accounting.

11 Accounting of fair value hedge

11.1 A fair value hedge, which qualifies for hedge accounting after meeting the conditions in paragraph 7 & 8 above shall be accounted for as follows :

a) the gain or loss from remeasuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount (for a non-derivative hedging instrument) shall be recognised in profit or loss; and

b) the gain or loss on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognised in profit or loss. This applies if the hedged item is otherwise measured at cost. Recognition of the gain or loss attributable to the hedged risk in profit or loss applies if the hedged item is an available-for-sale financial asset.

11.2 A bank shall discontinue prospectively the hedge accounting specified in paragraph 11.1 above if :

a) the hedging instrument expires or is sold, terminated or exercised;

b) the hedge no longer meets the criteria for hedge accounting specified in paragraph 7 & 8 above;

c) the entity revokes the hedge designation.

11.3 Any adjustment arising from paragraph 11.2 above to the carrying amount of the hedged financial instrument for which effective interest method is used (or in the case of a portfolio hedge of interest rate risk, to the separate balance sheet line item) shall be amortised to profit or loss. Amortisation may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. The adjustment is based on a recalculated effective interest rate at the date amortisation begins. However, if, in the case of a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), amortising using a recalculated effective interest rate is not practicable, the adjustment shall be amortised using a straight-line method. The adjustment shall be amortised fully by maturity of the financial instrument or, in the case of a portfolio hedge of interest rate risk, by expiry of the relevant repricing time period.

11.4 When an unrecognised firm commitment is designated as a hedged item, the subsequent cumulative change in the fair value of the firm commitment attributable to the hedged risk is recognised as an asset or liability with a corresponding gain or loss recognised in profit or loss. The changes in the fair value of the hedging instrument are also recognised in profit or loss. When an entity enters into a firm commitment to acquire an asset or assume a liability that is a hedged item in a fair value hedge, the initial carrying amount of the asset or liability that results from the entity meeting the firm commitment is adjusted to include the cumulative change in the fair value of the firm commitment attributable to the hedged risk that was recognised in the balance sheet.

12 Accounting of cash flow hedge

12.1 A cash flow hedge, which qualifies for hedge accounting after meeting the conditions in paragraphs 6, 7 & 8 above shall be accounted for as follows:

a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognised in ‘Unrealised gain/ loss on Derivatives’ (UGD); and

b) the ineffective portion of the gain or loss on the hedging instrument shall be recognised in profit or loss.

12.2 More specifically, a cash flow hedge is accounted for as follows:

(a) the separate component of equity associated with the hedged item is adjusted to the lesser of the following (in absolute amounts):

i. the cumulative gain or loss on the hedging instrument from inception of the hedge; and
ii. the cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge;

(b) any remaining gain or loss on the hedging instrument or designated component of it (that is not an effective hedge) is recognised in profit or loss; and

(c) if a bank's documented risk management strategy for a particular hedging relationship excludes from the assessment of hedge effectiveness a specific component of the gain or loss or related cash flows on the hedging instrument that excluded component of gain or loss is recognized in profit and loss account.

12.3 If a hedge of a forecast transaction subsequently results in the recognition of a financial asset or a financial liability, the associated gains or losses that were recognized directly in UGD shall be re-classified into profit or loss in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as in the periods that interest income or interest expense is recognized). However, if a bank expects that all or a portion of a loss recognized directly in UGD will not be recovered in one or more future periods, it shall reclassify into profit or loss the amount that is not expected to be recovered.

12.4 In any of the following circumstances a bank shall discontinue prospectively the hedge accounting specified above:

(i) The hedging instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the bank's documented hedging strategy). In this case, the cumulative gain or loss on the hedging instrument that remains recognized directly in UGD from the period when the hedge was effective shall remain separately recognized in UGD until the forecast transaction occurs the relevant hedge accounting rule will be applied.

(ii) The hedge no longer meets the criteria for hedge accounting. In this case, the cumulative gain or loss on the hedging instrument that remains recognized directly in UGD from the period when the hedge was effective) shall remain separately recognized in UGD until the forecast transaction occurs. When the transaction occurs, the relevant hedge accounting rule will be applied.

(iii) The forecast transaction is no longer expected to occur, in which case any related cumulative gain or loss on the hedging instrument that remains recognized directly in UGD from the period when the hedge was effective shall be recognized in profit or loss. A forecast transaction that is no longer highly probable may still be expected to occur.

(iv) The bank revokes the designation. For hedges of a forecast transaction, the cumulative gain or loss on the hedging instrument that remains recognized directly in UGD from the period when the hedge was effective shall remain separately recognized in UGD until the forecast transaction occurs or is no longer expected to occur. When the transaction occurs, the relevant hedge accounting rule will be applied. If the transaction is no longer expected to occur, the cumulative gain or loss that had been recognized directly in UGD shall be recognized in profit or loss.

12.5 Hedge accounting may be discontinued prospectively in any of the following circumstances :

(a) The hedging instrument expires or is sold, terminated or exercised.

(b) The hedge no longer meets the criteria for hedge accounting in paragraphs 7 & 8 above.

(c) The forecast transaction is no longer expected to occur.

(d) The bank revokes the hedge designation.

(e) The hedged item is settled.

12.6 Hedge accounting ceases prospectively from the beginning of the period in which the hedge effectiveness test has failed. All further fair value changes in a derivative hedging instrument are accounted as a DRA or DAC as the case may be. Future changes in the fair value of the hedged item, and any non-derivative hedging instruments, are accounted for as they would be accounted in the absence of hedge accounting.

12.7 Gains and losses arising on cash flow hedges from the effective period will remain in Unrealised gains/ losses on Derivatives until the related cash flow occur. Where a forecast transaction is no longer highly probable, but still expected to take place, previous gains continue to be deferred. However, once a forecast transaction is not expected to occur, any gain or loss is recognized immediately in profit and loss account.

13 Accounting of net investment

13.1 Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment, shall be accounted for similarly to cash flow hedges:

a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be reflected in ‘Unrealised gain/ loss on Derivatives; and

b) the ineffective portion of the gain or loss on the hedging instrument shall be recognised in profit and loss.

13.2 The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognised in ‘Unrealised gain/ loss on Derivatives shall be recognised in profit or loss on disposal of the foreign operation.

14 Accounting of unrealised gains / loss on derivatives

14.1 Credit balance in ‘Unrealised gain/loss on Derivatives’ should be included as a separate item under Schedule 5: ‘Other Liabilities and Provisions’. Credit balances in ‘Unrealised gain/loss on Hedging’ shall not be an eligible item of capital funds for capital adequacy purposes. Debit balance in ‘Unrealised gain/loss on Derivatives’ should be included as a separate item under Schedule 11: ‘Other Assets’. Since a debit balance in ‘Unrealised gain/loss on Derivatives’ is in the nature of intangible assets, it shall be deducted from Tier I capital for capital adequacy purposes.

15 Balance Sheet Disclosures

15.1 The purpose of the disclosures is to provide information that will enhance understanding of the significance of derivative instruments to banks’ profit and loss, cash flows and assist in assessing the amounts, timing and certainty of future cash flows associated with those instruments. In addition to giving information about particular financial instrument balances and transactions, banks are encouraged to provide a discussion of the extent to which financial instruments are used, the associated risks and the business purposes served. With regard to recognized financial instruments, to the extent that the information is presented on the face of the balance sheet, it is not necessary for it to be repeated in the notes. With regard to unrecognized financial instruments, however, information in notes or supplementary schedules is the primary means of disclosure.

15.2 In addition to the prescribed disclosures in ‘Notes on accounts’ furnished in Annex, the following disclosures are suggested:

(i) A discussion of management's policies for controlling the risks associated with financial instruments, including policies on matters such as hedging of risk exposures, avoidance of undue concentrations of risk and requirements for collateral to mitigate credit risks, provides a valuable additional perspective that is independent of the specific instruments outstanding at a particular time.

(ii) Disclosures may include a combination of narrative descriptions and specific quantified data, as appropriate to the nature of the instruments and their relative significance to the enterprise. Determination of the level of detail to be disclosed about particular financial instruments is a matter for judgment.

(iii) Classification of derivatives done according to the nature and intention.

(iv) The intention for holding a derivative i.e. for trading / speculation or hedging purpose should be made explicit.

(v) Discuss the method used for assessing the effectiveness of the hedge during the period under review.

(vi) Terms, conditions and accounting policies in respect of various types of financial instruments;

(vii) Interest rate risk disclosures;

(viii) Forex risk disclosures;

(ix) Hedges of anticipated future transactions.

Annex

Disclosures to be made in 'Notes on Accounts'

1. Forward Rate Agreement/ Interest Rate Swap

Items	Current year	Previous year
i) The notional principal of swap agreements		
ii) Losses which would be incurred if counterparties failed to fulfil their obligations under the agreements		
iii) Collateral required by the bank upon entering into swaps		
iv) Concentration of credit risk arising from the swaps **$**		
v) The fair value of the swap book **@**		

Note: Nature and terms of the swaps including information on credit and market risk and the accounting policies adopted for recording the swaps should also be disclosed.

$ Examples of concentration could be exposures to particular industries or swaps with highly geared companies

@ If the swaps are linked to specific assets, liabilities, or commitments, the fair value would be the estimated amount that the bank would receive or pay to terminate the swap agreements as on the balance sheet date. For a trading swap the fair value would be its mark to market value.

2. Exchange Traded Interest Rate Derivatives:

(Rs. Crore)

S.No.	Particulars	Amount
(i)	Notional principal amount of exchange traded interest rate derivatives undertaken during the year (instrument-wise) a) b) c)	
(ii)	Notional principal amount of exchange traded interest rate derivatives outstanding as on 31st March ____ (instrument-wise) a)	

	b) c)	
(iii)	Notional principal amount of exchange traded interest rate derivatives outstanding and not "highly effective" (instrument-wise) a) b) c)	
(iv)	Mark-to-market value of exchange traded interest rate derivatives outstanding and not "highly effective" (instrument-wise) a) b) c)	

3. Disclosures on risk exposure in derivatives

Qualitative Disclosure

Banks shall discuss their risk management policies pertaining to derivatives with particular reference to the extent to which derivatives are used, the associated risks and business purposes served. The discussion shall also include:

a) the structure and organization for management of risk in derivatives trading,

b) the scope and nature of risk measurement, risk reporting and risk monitoring systems,

c) policies for hedging and / or mitigating risk and strategies and processes for monitoring the continuing effectiveness of hedges / mitigants, and

d) accounting policy for recording hedge and non-hedge transactions; recognition of income, premiums and discounts; valuation of outstanding contracts; provisioning, collateral and credit risk mitigation.

Quantitative Disclosures

(Rs. in Crore)

Sl.No	Particular	Currency Derivatives	Interest rate derivatives
(i)	Derivatives (Notional Principal Amount)		
	a) For hedging		
	b) For trading		
(ii)	Marked to Market Positions [1]		
	a) Asset (+)		
	b) Liability (-)		
(iii)	Credit Exposure [2]		
(iv)	Likely impact of one percentage change in interest rate (100*PV01)		
	a) on hedging derivatives		
	b) on trading derivatives		
(v)	Maximum and Minimum of 100*PV01 observed during the year		
	a) on hedging		
	b) on trading		