ANNEX - 3

Terms and conditions applicable to Debt Capital Instruments to qualify for inclusion as Upper Tier II Capital

The debt capital instruments that may be issued as bonds / debentures by Indian banks should meet the following terms and conditions to qualify for inclusion as Upper Tier II Capital for capital adequacy purposes.

1. Terms of issue of Upper Tier II Capital Instruments

i) *Currency of issue:* Banks shall issue Upper Tier II Instruments in Indian Rupees. Instruments in foreign currency can be issued without seeking the prior approval of the Reserve Bank of India, subject to compliance with the under mentioned requirements:

a. Upper Tier II Instruments issued in foreign currency should comply with all terms and conditions (except the ‘step-up option’) applicable as detailed in the guidelines issued on January 25, 2006, unless specifically modified.

b. The total amount of Upper Tier II Instruments issued in foreign currency shall not exceed 25 per cent of the unimpaired Tier I Capital. This eligible amount will be computed with reference to the amount of Tier I Capital as on March 31 of the previous financial year, after deduction of goodwill and other intangible assets but before the deduction of investments.

c. This will be in addition to the existing limit for foreign currency borrowings by Authorised Dealers in terms of Master Circular on Risk Management and Inter-Bank Dealings.

d. Investment by FIIs in Upper Tier II Instruments raised in Indian Rupees shall be outside the limit for investment in corporate debt instruments. However, investment by FIIs in these instruments will be subject to a separate ceiling of USD 500 million.

ii) *Amount:* The amount of Upper Tier II Instruments to be raised may be decided by the Board of Directors of banks.

iii) *Limit:* Upper Tier II Instruments along with other components of Tier II capital shall not exceed 100% of Tier I capital. The above limit will be based on the amount of Tier I capital after deduction of goodwill and other intangible assets but before the deduction of investments.

iv) *Maturity Period:* The Upper Tier II instruments should have a minimum maturity of 15 years.

v) *Rate of interest:* The interest payable to the investors may be either at a fixed rate or at a floating rate referenced to a market determined rupee interest benchmark rate.

vi) *Options:* Upper Tier II instruments shall not be issued with a 'put option' or a 'step-up option'. However banks may issue the instruments with a 'call option' subject to strict compliance with each of the following conditions:

- Call options may be exercised only if the instrument has run for at least ten years;
- Call options shall be exercised only with the prior approval of RBI (Department of Banking Operations & Development). While considering the proposals received from banks for exercising the call option the RBI would, among other things, take into consideration the bank's CRAR position both at the time of exercise of the call option and after exercise of the call option.

vii) Lock-In Clause

a. Upper Tier II instruments shall be subjected to a lock-in clause in terms of which the issuing bank shall not be liable to pay either interest or principal, even at maturity, if

- o the bank's CRAR is below the minimum regulatory requirement prescribed by RBI, or
- o the impact of such payment results in bank's CRAR falling below or remaining below the minimum regulatory requirement prescribed by RBI.

b. However, banks may pay interest with the prior approval of RBI when the impact of such payment may result in net loss or increase the net loss provided CRAR remains above the regulatory norm. For this purpose 'Net Loss' would mean either (a) the accumulated loss at the end of the previous financial year; or (b) the loss incurred during the current financial year.

c. The interest amount due and remaining unpaid may be allowed to be paid in the later years in cash/ cheque subject to the bank complying with the above regulatory requirement. While paying such unpaid interest and principal, banks are allowed to pay compound interest at a rate not exceeding the coupon rate of the relative Upper Tier II bonds, on the outstanding principal and interest.

d. All instances of invocation of the lock-in clause should be notified by the issuing banks to the Chief General Managers-in-Charge of Department of Banking Operations & Development and Department of Banking Supervision of the Reserve Bank of India, Mumbai.

viii) *Seniority of claim:* The claims of the investors in Upper Tier II instruments shall be

- Superior to the claims of investors in instruments eligible for inclusion in Tier I capital; and
- Subordinate to the claims of all other creditors.

ix) *Discount:* The Upper Tier II instruments shall be subjected to a progressive discount for capital adequacy purposes as in the case of long-term subordinated debt over the last five years of their tenor. As they approach maturity these instruments should be subjected to progressive discount as indicated in the table below for being eligible for inclusion in Tier II capital.

Remaining Maturity of Instruments	**Rate of Discount (%)**
Less than one year	100
One year and more but less than two years	80
Two years and more but less than three years	60
Three years and more but less than four years	40
Four years and more but less than five years	20

x) *Redemption:* Upper Tier II instruments shall not be redeemable at the initiative of the holder. All redemptions shall be made only with the prior approval of the Reserve Bank of India (Department of Banking Operations & Development).

xi) Other conditions

(a) Upper Tier II instruments shall be fully paid-up, unsecured, and free of any restrictive clauses.

(b) Investment in Upper Tier II instruments by FIIs shall be within the limits as laid down in the ECB Policy for investment in debt instruments. In addition, NRIs shall also be eligible to invest in these instruments as per existing policy.

(c) Banks should comply with the terms and conditions, if any, stipulated by SEBI/other regulatory authorities in regard to issue of the instruments.

2. Compliance with Reserve requirements

(i) The funds collected by various branches of the bank or other banks for the issue and held pending finalisation of allotment of the Upper Tier II Capital instruments will have to be taken into account for the purpose of calculating reserve requirements.

(ii) The total amount raised by a bank through Upper Tier II instruments shall be reckoned as liability for the calculation of net demand and time liabilities for the purpose of reserve requirements and, as such, will attract CRR/SLR requirements.

3. Reporting requirements

Banks issuing Upper Tier II instruments shall submit a report to the Chief General Manager-in-charge, Department of Banking Operations & Development, Reserve Bank of India, Mumbai giving details of the debt raised, including the terms of issue specified at item 1 above together with a copy of the offer document soon after the issue is completed.

4. Investment in Upper Tier II Instruments issued by other banks/ FIs

- A bank's investment in Upper Tier II instruments issued by other banks and financial institutions will be reckoned along with the investment in other instruments eligible for capital status while computing compliance with the overall ceiling of 10 percent for cross holding of capital among banks/FIs prescribed vide circular DBOD.BP.BC.No.3/ 21.01.002/ 2004- 05 dated July 6, 2004 and also subject to cross holding limits.
- Bank's investments in Upper Tier II instruments issued by other banks/ financial institutions will attract a 100 per cent risk weight for capital adequacy purposes.

5. Grant of advances against Upper Tier II Instruments

Banks shall not grant advances against the security of the Upper Tier II instruments issued by them.

6. Classification in the Balance Sheet

Banks may indicate the amount raised by issue of Upper Tier II instruments by way of explanatory notes / remarks in the Balance Sheet as well as under the head" Hybrid debt capital instruments issued as bonds/debentures" under Schedule 4 - ' Borrowings'.