

## **Forward Rate Agreements and Interest Rate Swaps - Guidelines**

In the Governor's Statement on 'Mid-Term Review of Monetary and Credit Policy for 1998-99' announced on October 30, 1998, it was indicated that 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, the Reserve Bank of India has decided, in principle, to create an environment that would facilitate introduction of interest rate swaps.

Accordingly, it has been decided to allow scheduled commercial banks (excluding Regional Rural Banks), primary dealers and all-India financial institutions to undertake Forward Rate Agreements/ Interest Rate Swaps (FRAs/IRS) as a product for their own balance sheet management and for market making purposes. Participants who intend to undertake FRAs/IRS are, however, advised that before undertaking market making activity, they should ensure that appropriate infrastructure and risk management systems are put in place. Further, participants should also set up sound internal control system whereby a clear functional separation of trading, settlement, monitoring and control and accounting activities is provided.

Deregulation of interest rates which helped in making financial market operations efficient and cost effective has brought to the fore a wide array of risks faced by the market participants. To manage and control these risks, there has been a felt need for an appropriate financial instrument. Forward Rate Agreement (FRA) and Interest Rate Swap (IRS) are such instruments which can provide effective hedge against interest rate risks. To enable the market to use FRAs/ IRS and for smooth development of these products, guidelines for FRAs/IRS have been formulated and are set out below:

### **Description of the product**

2. A Forward Rate Agreement or an Interest Rate Swap provides means for hedging the interest rate risk arising on account of lendings or borrowings made at fixed/variable interest rates.
3. 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, on the settlement date, cash payments based on contract (fixed) and the settlement rate, are made by the parties to one another. The settlement rate is the agreed benchmark/reference rate prevailing on the settlement date.
4. 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 floating' rates of interest. Accordingly, on each payment date - that occurs during the swap period - cash payments based on fixed/floating and floating rates, are made by the parties to one another.

### **Participants**

5. Scheduled commercial banks (excluding Regional Rural Banks), primary dealers (PDs) and all-India financial institutions (FIs) are free to undertake FRAs/IRS 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 (corporates) own balance sheet exposures. No specific permission

from Reserve Bank would be required to undertake FRAs/IRS. However, participants when they start undertaking such transactions, will be required to inform Monetary Policy Department (MPD), Reserve Bank of India and abide by such reporting requirements as prescribed by the Reserve Bank from time to time.

6. Participants undertaking FRAs/IRS are, however, advised that before undertaking market making activity in FRAs/IRS, they should ensure that appropriate infrastructure and risk management systems such as ability to price the product and mark to market their positions, monitor and limit exposures on an ongoing basis, etc., are put in place.

### **Types of FRAs/IRS**

7. Banks/PDs/FIs can undertake different types of plain vanilla FRAs/IRS. Swaps having explicit/implicit option features such as caps/floors/collars are not permitted.

### **Bench Mark Rate**

8. The benchmark rate should necessarily evolve on its own in the market and require market acceptance. The parties are therefore, free to use any domestic money or debt market rate as benchmark rate for entering into FRAs/IRS, provided methodology of computing the rate is objective, transparent and mutually acceptable to counterparties.

### **Size**

9. There will be no restriction on the minimum or maximum size of 'notional principal' amounts of FRAs/IRS. Norms with regard to size are expected to emerge in the market with the development of the product.

### **Tenor**

10. There will be no restriction on the minimum or maximum tenor of the FRAs/ IRS.

### **Capital Adequacy**

11. Banks and financial institutions are required to maintain capital for FRAs/IRS, as per the stipulations contained in An-nexure 1. Primary dealers should follow the norms as indicated in Annexure 2.

### **Exposure Limits**

12. Banks, FIs and PDs have to arrive at the credit equivalent amount for the purposes of reckoning exposure to a counterparty. For this purpose participants may apply the conversion factors to notional principal amounts as per the original exposure method prescribed in Annexures 1 and 2. The exposure should be within sub-limit to be fixed for FRAs/ IRS to corporates/banks/FIs/PDs by the participants concerned. In case of banks and FIs, the exposure on account of FRAs/ IRS together with other credit exposures should be within single/group borrower limits as prescribed by RBI.

13. Further, while dealing with corporates, banks/FIs/PDs should exercise due diligence to ensure that they (corporates) are undertaking FRAs/IRS only for hedging their own rupee balance sheet exposures. Banks/FIs/PDs are advised to also obtain a certificate from the authorised signatory/signatories of corporate/s to the effect that the transactions undertaken by them

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**

14. Ideally, participants should undertake FRAs/IRS only for hedging underlying genuine exposures. However, recognising the crucial role played by the market maker in development of the product and creating of the market itself, participants have been allowed to undertake market making activity, which would involve at times dealing in the market without underlying exposure. However to ensure that market makers do not over extend themselves, market makers are required to place prudential limits on swap positions, which may arise on account of market making activity.

15. Scheduled commercial banks, should place various components of assets, liabilities and off-balance sheet positions (including FRAs, IRS) in different time buckets and fix prudential limits on individual gaps as per the procedure laid down in the Reserve Bank of India Circular No. BP.BC. 8/21.04.098 dated February 10, 1999, on ALM system. The FRAs/IRS, etc. undertaken by banks will have to be within the prudential limits for different time buckets, approved by Boards/Management Committees of banks.

16. Primary Dealers/Financial Institutions should identify swap positions in each maturity bucket and place prudential limits with the approval of their respective boards.

17. The prudential limits on swap positions, as detailed in paragraph 16, will require vetting by the Reserve Bank after approval of respective boards, as mentioned below.

#### **Institution**

#### **Reserve Bank's Department**

Primary Dealers

Internal Debt Management Cell

Financial Institutions

Financial Institutions Division, Department of Banking Supervision

18. While the above procedures for setting up of limits on 'swap positions' and exposure limits may form the bottomline for the risk management, participants who can employ more sophisticated methods such as Value at Risk (VaR) and Potential Credit Exposure (PCE) may do so. They are, however, advised to report the methods followed for VaR/PCE to Monetary Policy Department with a copy to the respective departments of RBI as mentioned below:

#### **Institution**

#### **Reserve Bank's Department/s**

Scheduled' Commercial  
Banks

Department of Banking Supervision and Department of Banking  
Operations Development

Primary Dealers

and Internal Debt Management Cell Financial Institutions Division,

Financial Institutions

Department of Banking Supervision

### **Accounting and Valuation**

19. 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. Participants should adopt suitable norms for accounting of FRAs/ IRS, on the basis of general accounting principles set out in Annexure 3, after the approval of their respective boards.

### **Documentation**

20. For the sake of uniformity and standardisation, participants could consider using ISDA documentation, as suitably modified to comply with these guidelines for undertaking FRAs/IRS transactions. Participants may also consider the changes as suggested in the Annexure-4 before finalising the documentation but after seeking appropriate legal advice. Institutions should further evaluate whether the counterparty has the legal capacity, power and authority to enter into FRAs/IRS transactions.

### **Internal Control**

21. Participants should set up sound internal control system. They 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.

22. A copy of the document detailing Product Policy and Internal Control System should be submitted to the Monetary Policy Department and to the respective departments of Reserve Bank as mentioned in paragraph 18 above.

### **Reporting**

23. Participants are required to report, as per the proforma indicated in Annexure-5, their FRAs/IRS operations on a fortnightly basis to Adviser-in-Charge, Monetary Policy Department, Reserve Bank of India, with a copy to respective departments as mentioned in paragraph 18 above.

24. These guidelines are intended to form the basis for development of Rupee derivative products such as FRAs/IRS in the country. The guidelines are subject to review, on the basis of development of FRAs/IRS market.

## **Annexure - 1 Capital Adequacy Norms Applicable To Banks And Financial Institutions For Undertaking Fras/Irs**

For reckoning the minimum capital ratio, the computation of risk weighted assets on account of FRAs/IRS should be done as per the two steps procedure set out below:

### **Step 1:**

The notional principal amount of each instrument is to be multiplied by the conversion factor given below:

<b>Original maturity</b>	<b>Conversion factor</b>
Less than one year	0.5 per cent
One year and less than two years	1.0 per cent
For each additional year	1.0 per cent

**Step 2:**

The adjusted value thus obtained shall be multiplied by the risk weightage allotted to the relevant counterparty as specified below:

Banks/All India Financial Institutions	20 per cent
All others (except Governments)	100 per cent

**Annexure – 2**

**Capital Adequacy for Primary Dealers on Interest Rate Contracts for Credit Risk**

Primary dealers undertaking Forward Rate Agreements and Interest Rate Swaps, will be required to fulfill the following minimum capital/capital adequacy requirements:

Over and above the minimum net owned funds, as defined under paragraph 4 of the 'Guidelines for Primary Dealers in the Government Securities Market', Primary Dealers will have to maintain additional capital at 12 per cent of Risk Weighted Assets (RWA) towards credit risk on Interest Rate Contracts. The methodology for these off-balance sheet items will be as under, notwithstanding what is stated in paragraph 6(iii) of the 'Guidelines for Primary Dealers in the Government Securities Market':

(i) The notional principal amount will be multiplied by the conversion factors given below to arrive at the adjusted value.

@ 0.5 per cent of notional principal value for original maturity of less than 1 year

@ 1.0 per cent for original maturity of one year and less than two years

@ 1.0 per cent for each additional year.

(ii) The adjusted value thus obtained shall be multiplied by the risk weight applicable to the counter party as specified below:

Banks/Financial Institutions	20 per cent
All others (except Government)	100 per cent

**Annexure - 3**

Participants may adopt suitable norms for accounting of Interest Rate Swaps and Forward Rate Agreements after the approval of their respective boards. Following may be used as general principles for framing such accounting norms:

## **Hedge Swaps**

- (i) Interest Rate Swap which hedges interest bearing asset or liability should generally be accounted for like the hedge of the asset or liability.
- (ii) The Swap that is accounted for like a hedge should be accounted for on accrual basis except the swap designated with an asset or liability that is carried at market value or lower of cost or market value in the financial statements. In that case the swap should be marked to market with the resulting gain or loss recorded as an adjustment to the market value of designated asset or liability.
- (iii) Gains or losses on the termination of swaps should be recognised when the offsetting gain or loss is recognised on the designated asset or liability. This implies that any gain or loss on the terminated swap would be deferred and recognised over the shorter of the remaining contractual life of the swap or the remaining life of the asset/liability.

### **(iv) Redesignation of Hedge items**

If a hedge is redesignated from one item of asset/liability to another item of asset/liability such redesignation should be accounted for as the termination of one hedge and acquisition of another. On the date of redesignation the swap should be marked to market and the mark to market value would be amortized over the shorter period of the remaining life of the swap or remaining life of the asset/liability. The offsetting mark to market entry adjustments would be treated as premium received or paid for hedge on the newly designated item of asset/liability and this would be amortized over the life of the redesignated asset/liability or remaining term of the swap whichever is shorter.

- (v) When participant is acting like a broker for matching parties and is not a Principal to the contract itself, then the fee should be recognised immediately as an income. In case where the bank acts like a Principal the fee should be amortized over the life of the contract.

## **Accounting for Trading Positions**

The following should be used as general principles for accounting of trading transactions:

- (i) Trading swaps should be marked to market with changes recorded in the income statement.
- (ii) Income and expenses relating to these swaps should be recognised on the settlement date.
- (iii) Fee should be recognised as immediate income or expenditure.
- (iv) Gains or losses on the termination of the swaps should be recorded as immediate income or expenses.

## **Disclosures**

The following should be disclosed in the note to the balance sheet:

- the notional principal of swap agreements;
- nature and terms of the swaps including information on credit and market risk and the accounting policies adopted for recording the swaps;
- quantification of the losses which would be incurred if counterparties failed to fulfil their obligation under the agreement;
- collateral required by the entity upon entering into swaps;
- any concentration of credit risk arising from the swaps. Examples of concentration could be exposures to particular industries or swaps with highly geared companies; and
- the "fair" value of the total swaps book. If the swaps are linked to specific assets, liabilities or commitments, the fair value would be the estimated amount that the entity would receive or pay to terminate the swap agreements at balance date. For a trading swap the fair value would be its mark to market value.

#### **Annexure - 4**

The following changes may be made in the ISDA Master Agreement:

- (i) In Clause 8 (a) the words "Subject to the laws and prevailing guidelines in India" may be inserted at the beginning.
- (ii) The words "Stamp Tax" wherever appearing in the Agreement may be substituted by the words "Stamp Duty".

There is a reference to Credit Support Document and Credit Support Provider in the document. In case any further documents/agreements are required to be executed under the given transactions, the provisions of the same will have to be drafted keeping in mind the prevailing laws and guidelines. However, in cases where no further documents are to be executed the reference to the same and to the provisions relating to Credit Support Default in the Agreement may be deleted. This may be done in the Schedule to the Agreement rather than the main Master Agreement. Similarly, if any, further changes are desired to be made to meet specific requirements of participants, it is desirable to do so in the Schedule rather than the main Master Agreement.

Clause 13(a) of the Agreement provides that the Agreement will be governed by and construed in accordance with the law specified in the Schedule. Hence, the applicable law will have to be mentioned in the Schedule to the Agreement. Participants may specify the applicable Law (e.g. Indian Law or English Law or US Law) as deemed appropriate by them, in the Schedule.

It may be further clarified that the change suggested in Clause 8(a) is only clarificatory in as much as all payments would in any case be subject to any Indian Laws or guidelines. The provision made in Clause 13 regarding applicable laws and jurisdiction stipulates the law that would apply to decide any dispute between the parties. Counterparties are free to modify the ISDA Master Agreement by inserting suitable clauses in the schedule to the ISDA Master to reflect the terms that the counterparties may agree to, including the manner of settlement of transactions and choice of governing law of the Agreement.

It may be mentioned that besides the ISDA Master Agreement, participants should obtain specific confirmation for each transaction which should detail the terms of the contract such as gross amount, rate, value date, etc. duly signed by the authorised signatories. It is also preferable to make a mention of the Master Agreement in the individual transaction confirmation.

**Annexure - 5**  
**Fortnightly Return On Forward Rate Agreements/Interest Rate Swaps**

Name of the Bank/Institution:

Fortnight ended:

**1. Gross Notional Amount (Rs. Crore):**

**Total** :  
*Of which* for Hedging :  
Market Making :

**2. FRAs/IRS contracted during the fortnight ended**

<b>Original Maturity</b>	<b>No. of Contracts</b>	<b>Notional Amount (Rs. Crore)</b>	<b>Floating# Rate (Range)</b>	<b>Fixed Rate (Range)</b>	<b>Floating@# Rate (Range)</b>
Upto 14 days					
15 - 28 days					
29 to 3 months					
3-6 months					
6-12 months					
More than one year					

# along with rates bench marks should also be mentioned in bracket.

@ rate pertaining to second leg,if the swap is 'floating to floating' in nature.

**3. FRAs/IRS outstanding as at the end of the fortnight ended**

<b>Residual Maturity/ Repricing Date*</b>	<b>No. of Contracts</b>	<b>Notional Amount (Rs. Crore)</b>	<b>Floating# Rate (Range)</b>	<b>Fixed Rate (Range)</b>	<b>Floating@# Rate (Range)</b>
Upto 14 days					
15 - 28 days					
29 to 3 months					
3-6 months					
6-12 months					
More than one year					

\* Residual maturity or repricing date, whichever is earlier, is to be reported.

# along with rates bench marks should also be mentioned in bracket.



@ rate pertaining to second leg,if the swap is 'floating to floating' in nature.