RBI / 2005-06 / 283

DBOD.No.BP.BC. 57 / 21.01.002 / 2005-2006

January 25, 2006

All Commercial Banks
(Excluding RRBs)

Dear Sir

Enhancement of banks' capital raising options for capital adequacy purposes

As you are aware, until recently, the capital adequacy ratio was applicable only to credit risk assumed by banks. Subsequently, capital requirement for market risks for the HFT portfolio was introduced during 2004-05. In addition, banks are required to provide capital for market risk for the AFS portfolio by March 31, 2006. This would require banks to augment their capital funds to ensure continued compliance with the regulatory minimum CRAR. With the transition to the new capital adequacy framework (Basel II) scheduled for March 2007, banks would need to further shore up their capital funds to meet the requirements under the revised framework. Under Basel II, the capital requirements are not only more sensitive to the level of risk but also apply to operational risks. Thus banks would need to raise additional capital on account of market risk, Basel II requirements, as well as to support the expansion of their balance sheets.

2. The Basel Capital Accord 1988 classifies capital under three Tiers. Tier 1 capital and Tier 2 capital include the following:

Tier 1 capital	Tier 2 capital
Permanent shareholders' equity; Perpetual non-cumulative preference shares; Disclosed reserves; Innovative capital instruments	Undisclosed reserves; Revaluation reserves; General provisions/general loan-loss reserves; Hybrid debt capital instruments (a range of instruments which combine characteristics of equity capital and debt); and Subordinated term debt;

Further, at the discretion of their national authority, banks may employ a third tier of capital (Tier 3), consisting of short-term subordinated debt for the *sole* purpose of meeting a proportion of the capital requirements for market risks.

3. At present, banks are not allowed to raise Tier 3 capital. The options for raising Tier 1 and Tier 2 capital funds as available to the banks in India in terms of the present guidelines on capital adequacy do not allow banks to raise capital funds through the issue of

a) Preference shares – both cumulative and non cumulative;
b) Innovative capital instruments for inclusion in Tier 1 capital; and
c) Hybrid debt instruments for inclusion in Tier 2 capital.

The feasibility of allowing banks to raise capital funds through the above mentioned instruments has been examined. However, since Tier 3 capital is short term in nature and is an optional item of capital for meeting a portion of banks' exposures to market risks, this option has not been considered for the present.

4. Taking into consideration the above and with a view to provide banks in India additional options for raising capital funds, to meet both the increasing business requirements as well as the Basel II requirements within the existing legal framework, it has been decided that banks may augment their capital funds by issue of the following additional instruments:

(a) Innovative Perpetual Debt Instruments (IPDI) eligible for inclusion as Tier 1 capital;
(b) Debt capital instruments eligible for inclusion as Upper Tier 2 capital;
(c) Perpetual non-cumulative Preference shares eligible for inclusion as Tier 1 capital - subject to laws in force from time to time; and
(d) Redeemable cumulative Preference shares eligible for inclusion as Tier 2 capital - subject to laws in force from time to time.

5. The guidelines governing the instruments at (a) and (b) above, indicating the minimum regulatory requirements are furnished in Annex 1 and Annex 2 respectively. Detailed guidelines regarding items (c) and (d) above will be issued separately as appropriate in due course. Banks should ensure that the instruments that may be issued by them are in strict conformity with these guidelines.

6. Please acknowledge receipt.

Yours faithfully

(Prashant Saran)
Chief General Manager-In-Charge

ANNEX 1

Terms and conditions applicable to Innovative Perpetual Debt Instruments for inclusion as Tier 1 capital

The Innovative Perpetual Debt Instruments (Innovative Instruments) that may be issued as bonds or debentures by Indian banks should meet the following terms and conditions to qualify for inclusion as Tier 1 Capital for capital adequacy purposes.

1. Terms of Issue of innovative instruments

i) *Currency of issue*

Banks shall issue innovative instruments in Indian Rupees. Banks shall obtain prior approval of the Reserve Bank of India, on a case-by-case basis, for issue of innovative instruments in foreign currency.

ii) *Amount*

The amount of innovative instruments to be raised may be decided by the Board of Directors of banks.

iii) *Limits*

Innovative instruments shall not exceed 15 per cent of total Tier 1 capital. The above limit will be based on the amount of Tier 1 capital after deduction of goodwill and other intangible assets but before the deduction of investments. Innovative instruments in excess of the above limits shall be eligible for inclusion under Tier 2, subject to limits prescribed for Tier 2 capital. However, investors' rights and obligations would remain unchanged.

iv) *Maturity period*

The innovative instruments shall be perpetual.

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

Innovative instruments shall not be issued with a 'put option'. However banks may issue the instruments with a call option subject to strict compliance with each of the following conditions:

a) Call option may be exercised after the instrument has run for at least ten years; and

b) Call option 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) Step-up option

The issuing bank may have a step-up option which may be exercised only once during the whole life of the instrument, in conjunction with the call option, after the lapse of ten years from the date of issue. The step-up shall not be more than 100 bps. The limits on step-up apply to the all-in cost of the debt to the issuing banks.

viii) Lock-In Clause

(a) Innovative instruments shall be subjected to a lock-in clause in terms of which the issuing bank shall not be liable to pay interest, if

1. the bank's CRAR is below the minimum regulatory requirement prescribed by RBI; OR
2. the impact of such payment results in bank's capital to risk assets ratio (CRAR) falling below or remaining below the minimum regulatory requirement prescribed by Reserve Bank of India;

(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 the CRAR remains above the regulatory norm.

(c) The interest shall <u>not</u> be cumulative.

(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.

ix) Seniority of claim

The claims of the investors in innovative instruments shall be

a) Superior to the claims of investors in equity shares; and

b) Subordinated to the claims of all other creditors.

x) Discount

The innovative instruments shall not be subjected to a progressive discount for capital adequacy purposes since these are perpetual.

xi) Other conditions

a) Innovative instruments should be fully paid-up, unsecured, and free of any restrictive clauses.

b) Investment in these instruments by FIIs and NRIs shall be within an overall limit of 49% and 24% of the issue respectively, subject to the investment by each FII not exceeding 10% of the issue and investment by each NRI not exceeding 5% of the issue.

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 innovative instruments will have to be taken into account for the purpose of calculating reserve requirements.

ii) The total amount raised by a bank through innovative 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 innovative 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 innovative instruments issued by other banks/ FIs

i) A bank's investment in innovative 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 6th July 2004 and also subject to cross holding limits.

ii) Bank's investments in innovative instruments issued by other banks/ financial institutions will attract a 100% risk weight for capital adequacy purposes.

5. Grant of advances against innovative instruments

Banks should not grant advances against the security of the innovative instruments issued by them.

6. Raising of innovative Instruments for inclusion as Tier 1 capital by foreign banks in India

Foreign banks in India may raise Head Office (HO) borrowings in foreign currency for inclusion as Tier 1 capital subject to the same terms and conditions as mentioned in items 1 to 5 above for Indian banks. In addition, the following terms and conditions would also be applicable:

i) Maturity period

If the amount of innovative Tier 1 capital raised as Head Office borrowings shall be retained in India on a perpetual basis .

ii) Rate of interest

Rate of interest on innovative Tier 1 capital raised as HO borrowings should not exceed the on-going market rate. Interest should be paid at half yearly rests.

iii) Withholding tax

Interest payments to the HO will be subject to applicable withholding tax.

iv) Documentation

The foreign bank raising innovative Tier 1 capital as HO borrowings should obtain a letter from its HO agreeing to give the loan for supplementing the capital base for the Indian operations of the foreign bank. The loan documentation should confirm that the loan given by Head Office shall be eligible for the same level of seniority of claim as the investors in innovative instruments capital instruments issued by Indian banks. The loan agreement will be governed by and construed in accordance with the Indian law.

v) *Disclosure*

The total eligible amount of HO borrowings shall be disclosed in the balance sheet under the head 'Innovative Tier 1 capital raised in the form of Head Office borrowings in foreign currency'.

vi) *Hedging*

The total eligible amount of HO borrowing should remain fully swapped in Indian Rupees with the bank at all times.

vii) *Reporting and certification*

Details regarding the total amount of innovative Tier 1 capital raised as HO borrowings, along with a certification to the effect that the borrowing is in accordance with these guidelines, should be advised to the Chief General

Managers-in-Charge of the Department of Banking Operations & Development (International Banking Section), Department of External Investments & Operations and Foreign Exchange Department (Forex Markets Division), Reserve Bank of India, Mumbai.

ANNEX 2

Terms and conditions applicable to Debt capital Instruments to qualify for inclusion as Upper Tier 2 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 2 Capital for capital adequacy purposes.

7. Terms of Issue of Upper Tier 2 Capital instruments

xii) Currency of issue

Banks shall issue Upper Tier 2 instruments in Indian Rupees. Banks shall obtain prior approval of the Reserve Bank of India, on a case-by-case basis, for issue of Upper Tier 2 instruments in foreign currency.

xiii) Amount

The amount of Upper Tier 2 instruments to be raised may be decided by the Board of Directors of banks.

xiv) Limits

Upper Tier 2 instruments along with other components of Tier 2 capital shall not exceed 100% of Tier 1 capital. The above limit will be based on the amount of Tier 1 capital after deduction of goodwill and other intangible assets but before the deduction of investments.

xv) Maturity period

The Upper Tier 2 instruments should have a minimum maturity of 15 years.

xvi) 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.

xvii) Options

Upper Tier 2 instruments shall not be issued with a ‘put option’. However banks may issue the instruments with a call option subject to strict compliance with each of the following conditions:

c) Call option may be exercised only if the instrument has run for at least ten years;

d) Call option 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.

xviii) Step-up option

The issuing bank may have a step-up option which may be exercised only once during the whole life of the instrument, in conjunction with the call option, after the lapse of ten years from the date of issue. The step-up shall not be more than 100 bps. The limits on step-up apply to the all-in cost of the debt to the issuing banks.

xix) Lock-In Clause

a) Upper Tier 2 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

1. the bank’s CRAR is below the minimum regulatory requirement prescribed by RBI OR

2. the impact of such payment results in bank’s capital to risk assets ratio (CRAR) falling below or remaining below the minimum regulatory requirement prescribed by Reserve Bank of India.

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.

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.

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.

xx) Seniority of claim

The claims of the investors in Upper Tier 2 instruments shall be

a) Superior to the claims of investors in instruments eligible for inclusion in Tier 1 capital; and

b) Subordinate to the claims of all other creditors.

xxi) Discount

The Upper Tier 2 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 2 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

xxii) Redemption

Upper Tier 2 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).

xxiii) Other conditions

a) Upper Tier 2 instruments should be fully paid-up, unsecured, and free of any restrictive clauses.

b) Investment in Upper Tier 2 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.

8. 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 2 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 2 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.

9. Reporting Requirements

Banks issuing Upper Tier 2 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.

10. Investment in Upper Tier 2 instruments issued by other banks/ FIs

i) A bank's investment in Upper Tier 2 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 6th July 2004 and also subject to cross holding limits.

ii) Bank's investments in Upper Tier 2 instruments issued by other banks/ financial institutions will attract a 100% risk weight for capital adequacy purposes.

11. Grant of advances against Upper Tier 2 instruments

Banks should not grant advances against the security of the Upper Tier 2 instruments issued by them.

12. Raising of Upper Tier 2 Instruments by foreign banks in India

Foreign banks in India may raise Head Office (HO) borrowings in foreign currency for inclusion as Upper Tier 2 capital subject to the same terms and conditions as mentioned in items 1 to 5 above for Indian banks. In addition, the following terms and conditions would also be applicable:

i) Maturity period

If the amount of Upper Tier 2 capital raised as Head Office borrowings is in tranches, each tranche shall be retained in India for a minimum period of fifteen years.

ii) Rate of interest

Rate of interest on Upper Tier 2 capital raised as HO borrowings should not exceed the on-going market rate. Interest should be paid at half yearly rests.

iii) Withholding tax

Interest payments to the HO will be subject to applicable withholding tax.

iv) Documentation

The foreign bank raising Upper Tier 2 capital as HO borrowings should obtain a letter from its HO agreeing to give the loan for supplementing the capital base for the Indian operations of the foreign bank. The loan documentation should confirm that the loan given by Head Office shall be eligible for the same level of seniority of claim as the investors in Upper Tier 2 debt capital instruments issued by Indian banks. The loan agreement will be governed by and construed in accordance with the Indian law.

v) *Disclosure*

The total eligible amount of HO borrowings shall be disclosed in the balance sheet under the head ‘Upper Tier 2 capital raised in the form of Head Office borrowings in foreign currency’.

vi) *Hedging*

The total eligible amount of HO borrowing should remain fully swapped in Indian Rupees with the bank at all times.

vii) *Reporting and certification*

Details regarding the total amount of Upper Tier 2 capital raised as HO borrowings, along with a certification to the effect that the borrowing is in accordance with these guidelines, should be advised to the Chief General Managers-in-Charge of the Department of Banking Operations & Development (International Banking Division), Department of External Investments & Operations and Foreign Exchange Department (Forex Markets Division), Reserve Bank of India, Mumbai.