RBI/2005-06/404
DBOD.BP.BC. 87 /21.01.002/2005-06

June 8, 2006

All Commercial Banks
(excluding RRBs)

Dear Sir,

Innovative Tier I/Tier II Bonds - Hedging by banks through Derivative Structures

It has come to our notice that some banks have undertaken swap transactions involving conversion of fixed rate rupee liabilities in respect of Innovative Tier I/Tier II bonds into floating rate foreign currency liabilities. Though the banks have apparently entered into such swaps to hedge the interest rate risk in respect of capital instruments thereby reducing cost, this exposes them to undue exchange risk in the event of adverse exchange rate movement. Banks are, therefore, advised not to enter into such swap transactions in respect of their Innovative Tier I/Tier II bonds.

2. Further, with regard to swaps already entered into banks are advised to follow the following procedure for accounting gains / losses arising out of such swap transactions:

i. The gains/losses arising out of such swap transactions should be computed separately;
ii. Losses, if any, should be fully provided for;
iii. Gains should be taken to a special reserve through Profit & Loss account;
iv. Any draw down from such reserve should be made only for meeting future losses arising out of swap transaction concerned.

3. Banks are also advised not to renew swap transactions entered into by them in respect of Tier I / Tier II bonds on expiry thereof.

Yours faithfully,

(Prashant Saran)
Chief General Manager-in-Charge