ANNEX - 3
(Cf. para 4.3.3)

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.

Terms of Issue of Upper Tier 2 Capital instruments in Indian Rupees

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

ii) Limits: Upper Tier 2 instruments along with other components of Tier 2 capital shall not exceed 100 per cent of Tier 1 capital. The above limit will be based on the amount of Tier 1 capital after deduction of goodwill, DTA and other intangible assets but before the deduction of investments, as required in paragraph 4.4.

iii) Maturity Period: The Upper Tier 2 instruments should have a minimum maturity of 15 years.

iv) 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.

v) 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:

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

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.

vi) 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.

vii) 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

I. the bank's CRAR is below the minimum regulatory requirement prescribed by RBI; **OR**

II. 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.

viii) 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.

ix) 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 (per cent)**
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) <u>Redemption</u>: 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).

xi) <u>Other conditions</u>:

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

b) Investment by FIIs in Upper Tier 2 Instruments raised in Indian Rupees shall be outside the limit for investment in corporate debt instruments, as fixed by the Govt. of India from time to time. However, investment by FIIs in these instruments will be subject to a separate ceiling of USD 500 million. 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. <u>Terms of issue of Upper Tier 2 capital instruments in foreign currency</u>

Banks may augment their capital funds through the issue of Upper Tier 2 Instruments in foreign currency without seeking the prior approval of the Reserve Bank of India, subject to compliance with the undermentioned requirements:

i) Upper Tier 2 Instruments issued in foreign currency should comply with all terms and conditions applicable to instruments issued in Indian Rupees.

ii) The total amount of Upper Tier 2 Instruments issued in foreign currency shall not exceed 25 per cent of the unimpaired Tier 1 capital. This eligible amount will be computed with reference to the amount of Tier 1 capital as on March 31 of the previous financial year, after deduction of goodwill and other intangible assets but before the deduction of investments, as per para 4.4.6 of this Master Circular.

iii) This will be in addition to the existing limit for foreign currency borrowings by Authorised Dealers stipulated in terms of Master Circular No. RBI/2006-07/24 dated July 1, 2006 on Risk Management and Inter-Bank Dealings.

3. **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.

4. **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 para 1 above, together with a copy of the offer document soon after the issue is completed.

5. **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 risk weight as per para 5.6.1 of this Master Circular, for capital adequacy purposes.

6. **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.

7. **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:

1) *Maturity Period:* If the amount of Upper Tier 2 capital raised as HO borrowings is in tranches, each tranche shall be retained in India for a minimum period of fifteen years.

2) *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.

3) *Withholding tax:* Interest payments to the HO will be subject to applicable withholding tax.

4) *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 HO 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.

5) *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'.

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

7) *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.