Capital adequacy norms – Treatment of preference shares – Grant equivalent

REF. DBS.FID No. C-9 /01.10.00/2001-02

November 29, 2001

To the CEOs of
The All-India Term Lending and Refinancing Institutions

Dear Sir,

Capital adequacy norms – Treatment of preference shares – Grant equivalent

Please refer to our Circular FID. No. 752/01.10.00/98099 dated April 21, 1999 on the captioned subject enumerating the treatment of preference shares, with original maturity of 20 years, issued by the FIs for the purpose of capital adequacy norms.

2. Under the extant instructions, for computation of the amount of "grant equivalent", the modalities for capturing the varying rates of dividend on the preference shares issued and the rate(s) of return on the utilisation / investment of the funds received by the FIs through the issuance of the preference shares, had not been explicitly spelt out. In this context, certain anomalies have been observed since the "grant equivalent" accrues to the FIs even when, in a structured transaction of issuance of preference shares, the quantum of cash outflows (on account of payment of dividend, dividend tax, where applicable, and income tax on investment income, etc.) exceeds the amount of cash inflows on account of income on deployment of the funds received. Thus, the "grant equivalent" gets reckoned as part of the regulatory capital even though there is no unrequited transfer of funds at below the market rate from the subscriber(s) of the preference shares to the FI concerned, which could give rise to " grant equivalent".

3. In order, therefore, to obviate such anomalies in future, the norms have been reviewed and it has been decided to modify the present instructions in the matter. Accordingly, in respect of preference shares (existing as well as those that may be issued in future) of 20 year original maturity, the amount of "grant equivalent" that can be reckoned towards the Tier 1 capital of the FIs would be computed after making the following adjustments in the amount received against subscription to the preference shares:

Amount received against the preference shares ……………(A)

LESS:

(a) the amount of corpus created in terms of our Circular DBS. FID. No. 752 dated 21 April 1999;

(b) the present value of the **dividend outflows** on the preference shares issued;

(c) the present value of the **dividend tax** payable

(d) the present value of the **tax payable** on the income from investment of the amount left after creating the corpus;

<u>ADD</u>:

(e) the present value of the cash inflows / income from the investment of the amount left after creating the corpus

Amount of "grant equivalent" that would} be counted towards Tier 1 capital…….. }	**= [A – (a + b + c + d) + e]**

4. In case, the amount left after creating the corpus is not deployed in separate identifiable investments / securities but is used as part of the overall working funds of the institution, then the cash inflow on account of income thereon should be notionally computed at the rate equal to the return on average working funds of the FI concerned during preceding financial year.

5. As the tax rates on dividend payments / investment income might change over the life of the preference shares / investments, the aforesaid computation should be reviewed at the balance sheet date every year, or more frequently if possible, to account for such changes and the amount of "grant equivalent" adjusted suitably. **All other instructions contained in our Circular FID. No. 752 dated 21 April 1999 and FID. No. 41 dated 28 April 1999 would remain unchanged.**

6. Please acknowledge receipt.

Yours faithfully,

(K. C. Bandyopadhyay)
Chief General Manager