Valuation of investments by banks

DBOD. BP. BC. 57/ 21.04.048 / 2001-02

January 10, 2002.
Pausha 20, 1923 (Saka)

All scheduled commercial banks
(excluding RRBs and LABs)

Dear Sir,

Valuation of investments by banks

Please refer to paragraph 39 of the Mid – Term Review of Monetary and Credit Policy for the year 2001 – 2002 cautioning the banks on the need for following a more prudent policy for utilising the gains realised on sale of investment in securities arising from the decline in interest rates and for building up adequate reserves to guard against any possible reversal of the interest rate environment in future due to unexpected developments. The need for building up adequate reserves to meet future depreciation requirement on investments was also discussed by the Reserve Bank of India recently with major commercial banks.

Withdrawn

2. In terms of circular DBOD. BP. BC. 24 / 21.04.048 / 99 dated March 30, 1999, banks were advised to appropriate the excess provision towards depreciation on investments to Investment Fluctuation Reserve Account (IFR) instead of Capital Reserve Account. Banks were permitted to utilise the amount held in IFR to meet, in future, the depreciation requirement on investment in securities. In the context of the substantial decline in the yield on securities, the position has been reviewed in consultation with major commercial banks and it is advised as under:

i. Banks should transfer maximum amount of the gains realised on sale of investment in securities to the Investment Fluctuation Reserve Account (IFR).
ii. The objective should be to achieve IFR of a minimum of 5 per cent of the portfolio, by transferring the gains realised on sale of investment, within a period of 5 years. Banks are, however, free to build up higher percentage of IFR

of upto 10 per cent of the portfolio depending on the size and composition of their portfolio, with the concurrence of their Board of Directors.

iii. Banks should ensure that the unrealised gains on valuation of the investment portfolio are not taken to the income account **<u>or</u>** to the IFR.

iv. In modification of the instructions contained in circular DBOD. No. BP. BC. 32 / 21.04.048 / 2001-2002 dated October 16, 2000, individual scrips held under the Available for Sale category should be marked to market at least at quarterly intervals.

v. The Investment Fluctuation Reserve, consisting of realised gains from sale of investments, would be eligible for inclusion in Tier 2 capital as hitherto.

vi. Banks are advised to assess the impact of changes in interest rates on their investment portfolio. In this connection, a reference is invited to circular DBOD. No. BP (SC). BC 98 / 21.04.103 / 99 dated October 7, 1999 setting out detailed guidelines on risk management systems, including management of interest rate risk. Banks have been advised therein to fix a definite timeframe for moving over to VaR and Duration methods for measurement of interest rate risk. Banks may initiate appropriate steps in this direction.

vii. The instructions contained in circular DBOD. No. BP. BC. 32 / 21.04.048 / 2000 –2001 dated October 16, 2000, in terms of which banks are permitted to transfer balances from IFR to Profit and Loss Account to meet the depreciation requirement on investment as a ‘below the line’ item would continue, as hitherto.

3. The above guidelines will be reviewed after one year in the light of the experience gained by banks and other developments, etc.

4. Please acknowledge receipt.

Yours faithfully.

(M.R. Srinivasan)
Chief General Manager in-Charge

Withdrawn