Discussion Paper
on
Review of Prudential Norms for Classification, Valuation and Operations of Investment Portfolio of Commercial Banks

Reserve Bank of India

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List of Select Abbreviations

AFS	Available for Sale
ALM	Asset Liability Management
B R Act	Banking Regulation Act, 1949
BCBS	Basel Committee on Banking Supervision
CET 1	Common Equity Tier 1
DTL	Demand and Time Liabilities
FASB	Financial Accounting Standards Board
FEDAI	Foreign Exchange Dealers' Association of India
FVTPL	Fair Value Through Profit and Loss
GFC	Global Financial Crisis
HFT	Held for Trading
HTM	Held to Maturity
IAS	International Accounting Standard
IASB	International Accounting Standards Board
ICAI	Institute of Chartered Accountants of India
IFR	Investment Fluctuation Reserve
IFRS	International Financial Reporting Standards
IRA	Investment Reserve Account
MTM	Marked to Market
NBFCs	Non-Banking Financial Companies
NDS-OM	Negotiated Dealing System- Order Matching
SLR	Statutory Liquidity Ratio
SPPI	Solely Payments of Principal and Interest on Principal Outstanding
SR	Securitisation Receipt
US GAAP	United States Generally Accepted Accounting Principles
VaR	Value at Risk

Executive Summary

Extant instructions[1] pertaining to the prudential norms on the classification and valuation of investment portfolio are largely based on the Report of Informal Group on Valuation of Banks' Investment Portfolio (Convenor: Dr T C Nair), which was submitted in 1999. The recommendations of this Informal Group culminated in the issue of prudential guidelines on investment portfolio in October 2000[2], which forms the basis of our current norms.

2. There have been significant developments in the global prudential framework, accounting standards as well as in the financial markets-both domestic and global in the last two decades. While RBI has been tweaking the guidelines in response to situations as they emerge, a comprehensive review has not been undertaken so far, resulting in a wide gap between our norms and the global standards and practices.

3. In this backdrop, this Discussion Paper (DP) reviews the rationale and the evolution of the current framework, the corresponding global standards, and developments in the financial markets before framing its proposals. The DP proposes to comprehensively align the prudential framework with global standards, while retaining some elements considering the domestic context. The key proposals are:

a) The investment portfolio shall be categorised into three categories viz. Held to Maturity (HTM), Available for Sale (AFS) and Fair Value through Profit and Loss Account (FVTPL). Within FVTPL, Held for Trading (HFT) shall be a sub-category aligned with the specifications of 'Trading Book' as per the Basel III framework[3].

b) Only debt instruments with fixed or determinable payments and fixed maturity with the intent of holding till maturity shall be classified under HTM. Non-SLR securities such as corporate bonds which satisfy these criteria can therefore be

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[1] Reserve Bank of India (Classification, Valuation and Operation of Investment Portfolio of Commercial Banks) Directions, 2021

[2] 'Guidelines for Classification and Valuation of Investments by Banks' issued vide circular DBOD.No.BP.BC.32/21.04.048/2000-2001 dated October 16, 2000

[3] RBC 25 of the Basel Framework defines the boundary conditions between the banking book and the trading book

permitted to be held in HTM. As an exception, investments in the equity shares of subsidiaries, associates and joint ventures shall also be carried at cost under HTM.

c) The ceiling on investments in HTM as a percentage to total investments as also the ceiling on SLR securities that can be held in HTM shall be dispensed with. However, the controls for sales out of HTM (barring certain existing exemptions) shall be tightened to ensure that the basic principles and tenets for classification of securities as HTM and valuing them at cost is not invalidated.

d) Debt instruments which the bank intends to either hold till maturity or sell before maturity shall be eligible for AFS. Banks shall also have the irrevocable option to classify equity investments at initial recognition under AFS.

e) FVTPL is the residual category i.e. all investments that do not qualify for inclusion in HTM or AFS shall be categorised as FVTPL. Illustratively, investments in Securitisation Receipts (SRs), mutual funds, alternate investment funds, equity shares (excluding certain exceptions), derivatives (including those undertaken for hedging), etc. which do not have any contractually specified periodic cash flows that are solely payments of principal and interest on principal outstanding (‘SPPI criterion’) shall be classified as FVTPL.

f) All investments and derivatives shall be valued at fair value on initial recognition. Unless the facts and circumstances suggest otherwise, it shall be presumed that the acquisition cost is the fair value. However, where this is not the case, the same shall be adjusted as a Day 1 gain/loss in the Profit and Loss Account if such securities are quoted or priced using market-based inputs. Where the acquisition cost is not the same as the fair value and the security is not quoted and cannot be priced using market-based inputs, the loss, if any shall be immediately recognised while the gains shall be deferred.

g) Securities held in HTM shall be carried at cost as hitherto and shall not require marking to market after initial recognition with any discount or premium on the acquisition being amortised over the life of the instrument. However, on a quarterly basis, banks shall need to assess any permanent diminution in value (i.e., an ‘Impairment Test’) and the impairment, if any, shall be debited to the Profit and Loss account.

h) Securities held in AFS shall be marked to market (MTM) at least on a quarterly, if not more frequent basis. Such MTM gains and losses shall be directly credited/ debited to AFS-Reserve, without routing through the Profit and Loss Account. While in line with Basel norms, the AFS-Reserve shall be reckoned as Common Equity Tier (CET) 1, as matter of prudence and in harmonisation with the requirements[4] of the Companies Act, 2013, unrealised MTM gains transferred to AFS-Reserve shall not be available for distribution as dividend. Upon sale or maturity of a debt instrument in AFS category, the accumulated realised gain/ loss shall be credited/ debited to the Profit and Loss Account. However, where banks had exercised the irrevocable option to classify an equity investment under AFS[5], the realised gain/ loss shall continue to remain in AFS-Reserve.

i) The securities held in FVTPL shall be fair valued and the resultant gains/ losses shall be directly credited/ debited to the Profit and Loss Account. Securities held within the HFT sub-category shall be subject to daily MTM while other securities within FVTPL shall be marked to market at least on a quarterly, if not more frequent basis.

j) In order to maintain the consistency of classification and measurement, reclassification between categories shall be prohibited. At the time of transition, banks shall be allowed a one-time option to re-classify their financial instruments and adjust the gains/losses on such reclassification in their reserves.

k) Banks shall carry equity investments in their subsidiaries, joint ventures and associates only at cost under HTM (as an exception to the HTM rule of only allowing debt instruments) subject to provision for permanent diminution, if any. This would *inter-alia* reduce the subset of unlisted equity investments requiring fair valuation.

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[4] Section 123 of the Companies Act, 2013 *inter-alia* excludes unrealized gains while computing profits available for distribution of dividend.

[5] The rationale to allow equity instruments in AFS is that in a few cases banks maybe holding certain equity instruments for strategic purposes for non-contractual benefits rather than increases in its value. While the benefit is that such equity instruments shall not be subject to an impairment model, a disincentive to equity instruments in AFS is that even realised gains shall not be recycled to the Profit and Loss Account. The intent is that banks carefully consider their decision of placing an equity instrument in AFS.

l) To address concerns relating to valuation, a valuation hierarchy shall be defined with three Levels: Level 1 (unadjusted quoted prices in active markets), Level 2 (other than Level 1, but valuation based largely on market observable inputs) and Level 3 (unobservable inputs). Gross unrealised gains arising from Level 3 financial instruments shall be reduced from regulatory capital as well as (where recognised in P&L) excluded from profits available for dividend.

m) Investment Reserve Account (IRA) shall be discontinued and its balance shall be transferred to any reserve under "Revenue and Other Reserves" which is reckoned for CET 1. Investment Fluctuation Reserve (IFR) may continue and be recalibrated over a phased period of say three years.

n) Disclosures shall be made of carrying amounts and fair values of each category and class of investments, gains/losses recognised in the Profit and Loss Account and in AFS-Reserve, disclosures as per fair value hierarchy, etc. to enhance transparency and market discipline.

o) The asymmetric treatment of fair value gains and losses in the investment portfolio and the absence of a comprehensive guidance on the accounting of derivatives especially hedge accounting may have attenuated the development of interest rate and credit derivative markets. Allowing symmetric treatment would address this issue to some extent. Further, the Institute of Chartered Accountants of India (ICAI) may consider updating its Guidance Note on Accounting for Derivatives Contracts for the presentation framework of banks. Banks shall be advised to comply with the requirements of the ICAI guidance note.

p) With the introduction of electronic anonymous order matching systems like NDS-OM, a few instructions notably those pertaining to engagement of brokers need to be revisited.

4. Subject to feedback, it is proposed to revise the current framework with effect from April 1, 2023 with banks being allowed to make the transitional adjustments based on the MTM position as at that date in the balance of 'Reserves and Surplus'.

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1. Introduction

1.1. The basic framework for the RBI's current instructions[6] on Classification, Valuation and Operations in the Investment Portfolio was introduced in October 2000 with the issuance of 'Guidelines for Classification and Valuation of Investments by Banks'. These guidelines were based on the recommendations of the Informal Group on Valuation of Banks' Investment Portfolio (Convenor: Shri TC Nair). Considering that over two decades have elapsed since their introduction a need was felt to undertake a comprehensive review in light of developments in international best practices and domestic financial markets.

2. Evolution of the Framework

2.1. Prior to the introduction of the present system of classification (viz. Held to Maturity (HTM), Held for Trading (HFT) and Available for Sale (AFS)), banks were bifurcating[7] their investments into 'permanent' and 'current', based upon the recommendations of the Committee on Final Accounts (Chair: Shri Amitava Ghosh, 1991) and endorsed by the Committee on Financial System (Chair: Shri M Narasimham, 1991). While the permanent category was held at cost, the current category was carried at lower of cost or market value. Starting with an initial ceiling of 70 per cent in the permanent category in 1992, the policy stance evolved towards full marking to market approach of the investment portfolio to facilitate the development of an active and healthy secondary market in government securities. The ceiling on the permanent category was reduced in a phased manner over the 1990s until it reached 25 per cent by April 1999.

2.2. In 1999, the entire framework was reviewed by the Informal Group on Valuation of Banks' Investment Portfolio which *inter-alia* considered (a) the global best practices at the time as reflected in the requirements of the then draft International Accounting Standard (IAS) 39 on *Financial Instruments: Recognition and Measurement* and (b) the implications of marking to market the entire investment portfolio. The Group recommended continuing with the ceiling of 25 per cent in a permanent category. Apart from the permanent category

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[6] Reserve Bank of India (Classification, Valuation and Operation of Investment Portfolio of Commercial Banks) Directions, 2021

[7] Circular DBOD.No.BC.129/21.04.043/92 dated April 27, 1992

(subsequently referred to as HTM in RBI guidelines), the Group suggested introducing AFS and HFT with symmetric recognition of gains and losses. In order to address concerns pertaining to unrealised gains, it suggested the following mechanism:

(a) Securities classified in HFT category to be marked to market on a monthly if not more frequent basis. While the depreciation to be recognized in the income account, appreciation, if any, being unrealized, to be appropriated to the 'Investment Fluctuation Reserve' (IFR) through Income Account.

(b) Securities in AFS category to also be marked to market at the year-end or at more frequent intervals. The gain or loss on revaluation to be taken to the IFR without routing through the income account. In the event of insufficient balance in IFR, provision for depreciation to be made in the income account. In the event of sale/realization of any investment from this category, the actual amount realized shall be recognized in the income account.

2.3. Based on the recommendations of the Informal Group, the revised guidelines were issued in October 2000 with the following salient features:

(a) The entire investment portfolio of the banks to be classified under three categories viz. HTM, HFT and AFS.

(b) Securities acquired by the banks with the intention to hold up to maturity to be classified under HTM. Securities acquired by the banks with the intention to trade by taking advantage of the short-term price/ interest rate movements to be classified under HFT. Securities which do not fall within the above two categories should be classified under AFS. Thus, AFS was a residual category.

(c) Ceiling of 25 per cent of the bank's total investments was placed on investments under HTM with the following exemptions:

(i) Re-capitalisation bonds received from the Government of India

(ii) Investment in subsidiaries and joint ventures

(iii) Debentures / bonds deemed to be in the nature of an advance.

(d) Appropriation of profit on sale of investments in HTM to the ‘Capital Reserve Account’ after recognition in the Profit & Loss Account.

(e) Premium on HTM could be amortised over the residual maturity.

(f) HFT securities to be sold within 90 days other than due to exceptional circumstances (tight liquidity conditions, extreme volatility, market becoming unidirectional).

(g) Individual securities in the AFS to be marked to market at the year-end or at more frequent intervals. While the net depreciation under each classification (i.e., Government Securities, Other Approved Securities, Shares, Debentures & Bonds, Subsidiaries/ Joint Ventures and Others) to be recognised and fully provided for, the net appreciation under each classification to be ignored. Inter-classification netting not allowed.

(h) HFT to be revalued at monthly or more frequent intervals and the net appreciation/ depreciation in each classification to be recognised in Income Account.

(i) Banks allowed to shift investments to/from HTM category with the approval of the Board of Directors only once a year, normally at the beginning of the accounting year. Transfer of securities from one category to another, under all circumstances, should be done at the acquisition cost/ book value/ market value on the date of transfer, whichever is the least, and the depreciation, if any, on such transfer to be fully provided for.

(j) Provisions for depreciation in the AFS category to be debited to the Profit & Loss Account and an equivalent amount (net of tax benefit, if any, and transfer to Statutory Reserve) to be transferred, below the line, from the IFR to the Profit & Loss Account. Reversal of excess depreciation in the AFS to be credited to the Profit & Loss Account and an equivalent amount to be appropriated to the IFR.

2.4. Key developments after the introduction of the guidelines in 2000 were:

(a) In 2004[8], considering the unique requirement of maintenance of statutory liquidity ratio (SLR) of 25 per cent of demand and time liabilities (DTL), banks were allowed to exceed the 25 per cent ceiling on HTM if the excess (i) comprised only SLR securities; and (ii) total securities in HTM category were not more than 25 per cent of the DTL. At the same time, banks were precluded from placing any fresh non-SLR securities in HTM barring a few exceptions specified in later circulars.

(b) Subsequently, in 2013[9], the excess SLR in HTM limits were aligned with reduction in SLR itself barring certain periods where special dispensations were given considering extraordinary circumstances.

(c) As regards IFR, vide circular dated January 10, 2002, banks were advised to transfer the maximum amount of realised gains to IFR with the objective to achieve a minimum IFR of 5 per cent of the portfolio (HFT+AFS)[10] within a period of 5 years. However, later in 2005, with the introduction of capital charge on market risk, IFR was discontinued. Instead excess depreciation was appropriated to Investment Reserve Account (IRA). Almost 13 years after its discontinuance, IFR was reintroduced, vide circular dated April 2, 2018, to be created out of realised gains (or available net profits if they were lower than realised gains) to achieve an IFR of 2 per cent of the AFS+HFT portfolio within three years. IFR was to be treated as a part of Tier 2 capital.

2.5. *Derivatives:* In the absence of any mandatory accounting standard on derivatives, banks follow a collection of instructions based on RBI instructions, accounting standards and guidance notes issued by the Institute of Chartered Accountants of India (ICAI), FEDAI circulars, etc. However, in most cases, they result in the derivatives being marked to market, with gains/ losses being recognised in the statement of profit and loss.

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[8] DBOD.No.BP.BC.37/21.04.141/2004-05 dated September 2, 2004
[9] DBOD.No.BP.BC.92/21.04.141/2012-13 dated May 15, 2013

[10] Clarified vide circular dated May 3, 2002

3. Developments in Financial Markets

3.1. Financial markets in India up to the 1990s were characterised[11] by captive markets for government securities, administered interest rates, pegged exchange rates, reliance on central bank funding and current and capital account restrictions. Developments[12] in the last two decades have facilitated transition to a regime characterised by market determined interest and exchange rates with vibrant government securities and capital markets. The fact that the sovereign yield curve now spans up to 40 years is largely attributable to the initiatives taken over the last two decades.

4. Global Standards

Financial Reporting Standards

4.1. The global standards on classification, measurement and valuation of investments are codified in accounting standards – two major standards being the International Financial Reporting Standards (IFRS)[13] issued by the International Accounting Standards Board (IASB), and the United States Generally Accepted Accounting Principles (US GAAP) codified by the Financial Accounting Standards Board (FASB) of the United States of America (USA).

4.2. As per the IASB's website over 100 jurisdictions notably, Australia, Brazil, Canada, China, European Union, Hong Kong, Russia, Singapore, South Africa, South Korea and United Kingdom require or permit the use of IFRS for financial reporting purposes. Many of these jurisdictions such as Australia, Korea, Hong Kong and Singapore have converged their local accounting standards with IFRS. On the other hand, there are a few jurisdictions such as Argentina, Mexico and India that still require banks to follow their local GAAP. While USA has not converged/ adopted IFRS, it allows foreign incorporated entities listed in USA to

[11] Gopinath, Shyamala (2008) Financial Markets in India: Recent Developments and Challenges

[12] Establishment of Clearing Corporation of India Limited (CCIL), operationalization of NDS, introduction of CBLO and later Tri-party Repo, establishment of Financial Benchmarks India Limited (FBIL), etc.

[13] Includes International Accounting Standards (IAS) issued by the erstwhile International Accounting Standards Committee (IASC) which were subsequently adopted by the IASB.

present financial statements for listing purposes under IFRS. Switzerland and Japan allow listed entities the option to follow IFRS.

4.3. In the Indian financial system, listed Non-Banking Financial Companies (NBFCs) and other NBFCs with net worth of ₹250 crore or more have transitioned to IFRS converged Indian Accounting Standards (Ind AS) as per the roadmap notified by the Ministry of Corporate Affairs, Government of India.

Basel Norms

4.4. The Basel norms *inter-alia* endeavour to ensure that banks have sufficient regulatory capital against market risk. The first Basel accord (Basel I) published in 1988 (effective from 1992) focussed primarily on credit risk, with little coverage on market or other risks. The need to provide an explicit capital cushion for the price risks to which banks are exposed, particularly those arising from their trading activities led to the January 1996[14] amendment to the Basel I Capital Accord to incorporate Market Risks. This was subsequently incorporated into the Basel II Accord of 2004.

4.5. The global financial crisis (GFC) exposed several shortcomings of the Basel framework and the BCBS *inter-alia* initiated a fundamental review of the market risk framework. The first consultative document was published in May 2012 and followed by a series of publications culminating in the revised framework for capital requirements for market risk in 2019[15]. The salient features of this framework are:

(a) Clearly defined boundary between the trading book and the banking book.

(b) An internal models approach that relies upon the use of expected shortfall models rather than VaR and sets out separate capital requirements for risk factors that are deemed non-modellable.

(c) A standardised approach that is risk-sensitive and is designed and calibrated to serve as a credible fall-back to the internal models' approach.

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[14] https://www.bis.org/publ/bcbs23.pdf

[15] Minimum capital requirements for Market Risk, issued in January 2019 (rev. February 2019). Available at https://www.bis.org/bcbs/publ/d457.pdf and incorporated into the consolidated Basel Framework available at https://www.bis.org/basel_framework/

(d) A simplified alternative to the standardised approach that entails application of a multiplier to the capital requirements computed under the Basel II standardised approach.

4.6. One of the key changes is the definition of the trading book as the BCBS believed that weaknesses in the boundary between the banking and trading books led to supervised entities misusing the lower capital charge available in the trading book. While trading intent continues to be an important feature of the revised definition, it supplements this with prescriptive rules. A key requirement for eligibility for trading book is that banks must daily fair value any trading book instrument and recognise any valuation change in the profit and loss account. Instruments held for short-term resale, profiting from short-term price movements, locking in arbitrage profits and hedging these risks would qualify for trading book capital treatment. Certain instruments such as unquoted equity shares, securitisation warehousing, retail and SME credit need to be mandatorily assigned to the banking book. Typically trading book instruments would be designated as FVTPL under IFRS or HFT under US GAAP.

5. Need for review of extant norms

5.1. The extant framework, which is over two decades old, was designed on the then applicable global best practices[16] while also considering the level of development of our financial markets at that point in time. There have since been significant developments over the last two decades in the global prudential framework, accounting standards as well as in our domestic financial markets.

5.2. On the financial reporting front, IAS 39 (upon which our extant framework was developed) has been replaced by IFRS 9, and IFRS itself has found larger global acceptance. On the prudential side, the Basel norms for market risk have also undergone a review with a revised definition of trading book (proposed to be implemented in 2023) predicated on an IFRS based categorisation. Meanwhile our financial markets, especially the Government securities market has

[16] The Informal Group on Valuation of Banks' Investment Portfolio based its recommendations on IAS 39 which was to replace IAS 25 from January 1, 2001.

witnessed substantial development and is much better placed to provide reliable pricing information.

5.3. Feedback received in the past from banks and our supervisory teams have also indicated some issues in the current framework as detailed below:

(a) Securities held in HTM do not require to be marked to market, built upon the premise that these shall be held until maturity and the realisable value of these securities shall not be affected by interest rate movements. The current framework does not prohibit[17] sales out of HTM and regulations permitting annual shifting to/from HTM as well as special dispensations allowing shifting, further invalidate the assumption that HTM securities shall indeed be kept till maturity.

(b) Non-SLR securities such as corporate bonds should be allowed to be held under HTM, if the intent is to hold such bonds till maturity in line with their ALM/investment mandate.

(c) Given the development in the financial markets and the sophistication of banks' treasuries, ceilings prescribed for holding under HTM category should be removed.

(d) Extant norms for AFS/HFT require the recognition of depreciation while not allowing the recognition of net appreciation. In addition to not being in alignment with the global standards, such asymmetric treatment stifles the development of derivative markets which could be used for hedging risk. Further, the depreciation/appreciation is done for a block of specific sub-sets of securities and the book value of the securities remains unchanged.

(e) Barring the ceiling on holding period (90 days for HFT) and greater valuation frequency (monthly for HFT vis-à-vis quarterly for AFS), the accounting treatment for AFS and HFT is similar. This leads to blurring of the distinction between the AFS and HFT classifications, with the result that most of the trading is also being conducted out of AFS rather than HFT, which distorts the trading book. The revised trading book requirements in the Basel III norms (which are to be implemented in 2023) are also

[17] The extant framework only requires a disclosure where such sales exceed 5 per cent of the opening book value of HTM subject to certain exceptions.

incompatible with the current framework Therefore, there is a need to articulate a trading book which complies with the boundary conditions laid down in the Basel norms.

There is a need to review the IFR requirement in light of capital requirements for market risk, convergence to Ind AS and possibility of introducing symmetric treatment of gains and losses.

Question 1: Are there any other important issues pertaining to the investment portfolio that should be taken up for consideration?

6. Guiding Principles for updating of prudential norms

6.1. In updating the current norms, the Bank has considered the following principles:

(a) Investments should be reflected in financial reporting in a robust and consistent manner that is in line with their economic substance and global best practices.

(b) The valuation methodology, sources of uncertainty in the estimation of fair value and the risks in the investment portfolio should be disclosed thereby enhancing the transparency of the financial statements.

(c) Undue need for interpretation may be avoided by reducing complexity. Further, arbitrary rules that may not have justification in economic substance may be avoided.

(d) Inconsistencies between the accounting and regulatory capital assessment framework should be minimised.

(e) The issues specific to the Indian context should be addressed and given due weightage in the revised framework.

Question 2: Are there any other overarching principles that the RBI should consider while updating the current framework?

7. Proposed Framework

7.1. The proposals for updating the classification, measurement and disclosure requirements of the investment portfolio and derivatives are grouped under the following broad heads:

(a) Classification
(b) Initial recognition and measurement
(c) Subsequent measurement
(d) Reclassification between measurement categories
(e) Limits for investments in HTM
(f) Non-SLR securities in HTM
(g) Valuation
(h) Disclosures

Classification

Proposal (1)

7.2. It is proposed that the investment portfolio of banks[18] should be categorized under three categories viz. (i) HTM, (ii) AFS and (iii) Fair Value through Profit & Loss Account (FVTPL). Banks shall decide the category of investment at the time of acquisition which shall be recorded in the investment proposals/ deal slips. In line with the format of financial statements prescribed under the Banking Regulation Act, 1949 ('BR Act'), the investments will continue to be disclosed as per the existing six classifications[19] in the balance sheet.

Held to Maturity

7.3. The securities acquired by banks shall be classified as HTM if both the following conditions are fulfilled:

(a) The securities are acquired with the intention and objective of holding them till maturity, i.e. the financial assets are held with an objective to collect the contractual cash flows; and

[18] including SLR securities and non-SLR securities

[19] (i) Government Securities, (ii) Other Approved Securities, (iii) Shares, (iv) Debentures & Bonds, (v) Subsidiaries/ Joint Ventures and (vi) Others

(b) The contractual terms of the securities give rise to cash flows on specified dates that are solely payments of principal and interest on principal outstanding ('SPPI criterion').

7.4. Only securities with fixed or determinable payments and fixed maturity with the intention of holding till maturity shall be classified as HTM. To further elaborate, only fixed income debt instruments with a specified maturity date/ call date such as Government Securities (including non-interest bearing recapitalisation bonds), non-convertible Corporate Bonds, redeemable preference shares, etc. with the intent to hold to maturity/ call date shall be allowed under HTM. Investment in equity shares (excluding banks' investment in the equity shares of their subsidiaries, associates and joint ventures), perpetual preference shares, and units of mutual fund schemes shall not qualify for inclusion in HTM category. As an exception to this principle, banks' investments in equity shares of their subsidiaries, associates and joint ventures shall be carried at cost[20].

Question 3. Should banks be given the irrevocable option at initial recognition (or on transition to this framework) to classify their investments in equity shares of their subsidiaries, associates and joint ventures under FVTPL or AFS like any other equity instrument instead of the mandatory classification as HTM proposed above?

Available for Sale

7.5. Securities that meet the SPPI criterion elaborated above and are acquired with the objective of both (a) collecting contractual cash flows and (b) selling securities shall be classified under AFS. To elaborate, where the bank's intent is flexible with respect to securities eligible for HTM, i.e., its intention is to both hold to maturity and sell (such as for asset liability management (ALM) purposes), such securities shall be classified under AFS. Additionally, at initial recognition,

[20] There are valid reasons for allowing accounting for investments in subsidiaries, joint ventures, and associates at either (i) cost or (ii) at fair value in accordance with global standards. However, to ensure uniformity in approach and consistency, banks shall carry equity investments in their subsidiaries, joint ventures and associates only at cost. This would also reduce the subset of equity investments that need to be fair valued.

banks shall have the irrevocable[21] option to classify equity shares (excluding equity shares in subsidiaries, associates and joint ventures) under AFS.

Fair Value through Profit & Loss

7.6. FVTPL is a residual category. All investments that do not qualify for inclusion in HTM or AFS shall be categorised as FVTPL. For instance, a 10 year G-Sec acquired with trading intent shall not qualify for HTM or AFS even though it meets the SPPI criterion and would therefore be classified as FVTPL. Illustratively, the following instruments shall not qualify to be considered as HTM or AFS since they do not meet the SPPI criterion and shall therefore need to be categorised as FVTPL:

(a) Equity shares other than (i) equity shares of subsidiaries, associates or joint ventures and (ii) equity shares where the irrevocable option to classify at AFS at initial recognition has been exercised

(b) Securitisation receipts

(c) Investments in Mutual Funds, Alternative Investment Funds, Real Estate Investment Trusts, Infrastructure Investment Trusts, etc.

(d) Investment in pass through certificates which represent the equity tranche of a securitisation transaction. Investments in other senior and mezzanine tranches shall need to be reviewed for their compliance with SPPI criterion.

(e) Bonds, debentures, etc. where the payment is linked to the movement in a particular index such as an equity index rather than an interest rate benchmark.

(f) Derivatives including hybrid investments that contain embedded derivatives.

Question 4. An indicative list of investments that do not meet the SPPI criteria is given above. Are there any other instruments that may be added to this list?

[21] The rationale to allow equity instruments in AFS is that in a few cases banks maybe holding certain equity instruments for strategic purposes for non-contractual benefits rather than increases in its value. While the benefit is that such equity instruments shall not be subject to an impairment model, a disincentive to equity instruments in AFS is that even realised gains shall not be recycled to the Profit and Loss Account. The intent is that banks carefully consider their decision of placing an equity instrument in AFS.

7.7. For ease of compliance with the revised Basel III norms on capital requirements for market risk, it is proposed that a sub-category Held for Trading (HFT) be created representing the Basel III compliant[22] trading book. Trading book shall include securities held with a trading intent or held for trading, i.e., positions held intentionally for short-term resale and/or with the intent of benefiting from actual or expected short-term price movements or to lock in arbitrage profits, and may include, for example, proprietary positions, and market-making.

Initial Recognition and Measurement

7.8. Presently investments are initially recognised at acquisition cost. Acquisition cost is very often representative of the fair value of the instrument. However, it is possible, that the acquisition cost may overvalue the investment leading to distortion both in the value of the assets and equity as well as the regulatory capital of the reporting entities that invested in such instruments. Therefore, there is a need to ensure that all financial instruments are initially recognised at their fair values in line with the global standards.

Proposal (2)

7.9. All investments and derivatives shall be measured at fair value on initial recognition. Unless facts and circumstances suggest otherwise, it shall be presumed that the acquisition cost is the fair value. Where the securities are quoted or the fair value can be determined based on market observable inputs (such as yield curve, credit spread, etc.) any gain or loss arising on account of a difference between fair value and acquisition cost shall be recognised as a 'day 1 gain/loss' in the Profit and Loss Account, under Schedule 14: Other Income within the subhead "Profit on revaluation of investments" or "Loss on revaluation of investments", as the case may be.

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[22] RBC 25 of the Basel Framework defines the boundary conditions between the banking book and the trading book, specifying the scope of the trading book, standards for assigning instruments to banking book and trading book, documentation, restrictions on movements between regulatory books, etc.
(Available at:
https://www.bis.org/basel_framework/chapter/RBC/25.htm?inforce=20191215&published=20191215)

7.10. In case the instruments are not quoted and cannot be valued based on market-based inputs, any loss arising on such valuation shall be recognised immediately, while any gains shall be amortised over the tenor of the instrument. The rationale for requiring immediate recognition of the loss rather than amortising it is also that Section 15 of the BR Act precludes a bank from paying any dividend on its shares until all its capitalised expenses (including preliminary expenses, organisation expenses, share-selling commission, brokerage, amounts of loss incurred and any other item of expenditure not represented by tangible assets) have been completely written off. As regards the period over which the gain shall be amortised, for debt instruments it shall be the earliest call date or the maturity date, while for unquoted equity instruments, the gain shall be set aside as a liability until the security is listed/ derecognised.

Subsequent Measurement

Proposal (3)

Held to Maturity

7.11. As hitherto, the securities held in HTM shall be carried at cost and shall not require to be marked to market after initial recognition. However, at least on a quarterly basis, banks shall need to assess any permanent diminution in value (i.e., an 'Impairment Test') and the impairment loss, if any, shall be charged to the Profit and Loss Account.

(i) Any discount or premium on the acquisition of such securities shall be amortised over the life of the instrument.

(ii) Banks will have to determine the MTM value of their HTM portfolio and disclose the same in their Notes to Accounts.

Question 5. Clause 9(a) of the Reserve Bank of India (Classification, Valuation and Operation of Investment Portfolio of Commercial Banks) Directions, 2021 (i.e. the Master Direction) provides certain tests for impairment. Is there a need for specifying more indicators of potential impairment?

Available for Sale

7.12. The securities held in AFS shall be marked to market at least on a quarterly basis, if not more frequently. Gains and losses shall be directly credited/ debited to a reserve named AFS-Reserve, without routing through the Profit & Loss Account. However, provisions for non-performing AFS shall be charged to the Profit and Loss Account.

7.13. The AFS-Reserve shall be reckoned as Common Equity Tier (CET) 1. The unrealised gains transferred to AFS-Reserve shall not be available for distribution as dividend.

7.14. Upon sale or maturity of a debt instrument in AFS category, the accumulated gain/ loss in the AFS-Reserve shall be transferred from the AFS-Reserve and credited/ debited to the Profit and Loss Account, above the line. However, in the case of equity instruments[23] where banks have exercised the irrevocable option to hold under AFS, there shall be no such transfer from AFS-Reserve to the Profit and Loss Account and such gains/ losses, even though realised shall remain in AFS-Reserve.

Fair Value through Profit & Loss

7.15. The securities held in FVTPL shall be marked to market and the gains/ losses shall be directly credited/ debited to the Profit and Loss Account. Securities that are classified under the HFT sub-category within FVTPL shall be marked to

[23] AFS – reserves, similar to Fair Value through Other Comprehensive Income (FVOCI), under Ind AS, is intended for instruments where the objective could be either hold to maturity or sell. In such a case by parking the unrealised gains/ losses in OCI/reserves and recognising it in profit or loss on derecognition, performance is measured in a manner as if the security had originally been classified as amortised cost. Impairment is required to be recognised in the statement of profit or loss for FVOCI/AFS debt instruments. On the other hand, under Ind AS, for equity investments, the default category is FVTPL. However, as an <u>exception</u>, taking cognisance of the fact that sometimes investors may hold shares for strategic reasons rather than for increase in its value, the standards allows equity to be recognised in FVOCI/reserves. While there is no impairment charge on such equity investments, any gains/loss on derecognition is not brought back ('recycled') to the Statement of Profit or Loss. More information about equity under FVOCI is available in an article by Ms Sue Lloyd on 'IFRS 9 and equity investments' available on the IFRS website (https://www.ifrs.org/news-and-events/news/2018/04/ifrs-9-and-equity-investments/)

market on a daily basis, where other securities in FVTPL shall be marked to market at least on a quarterly, if not more frequent basis.

7.16. Banks in India hold more than ₹15 lakh crore of investment in their AFS and HFT portfolios which are subjected to MTM. During volatile market conditions, banks run the risk of loss on these portfolios. Although RBI has allowed banks to enter into eligible derivative contracts to hedge underlying risks, participation of banks in derivative products for hedging purpose has been limited. One of the reasons being attributed by banks is the asymmetric accounting treatment of gains/losses in cash and derivatives market. The proposed norms will enable symmetric treatment of gains and losses in cash and derivatives portfolio and is expected to encourage banks to actively use the derivative products to manage underlying risks in their investment portfolio. Concerns pertaining to valuation arising from symmetric treatment are specifically discussed in paragraphs 7.23 to 7.30 below.

Reclassifications between measurement categories

7.17. IFRS does not permit reclassification between measurement categories, except in the rare circumstances of a change in the business model. Change in intention related to a particular financial asset, temporary disappearance of a market for financial asset, etc. are not considered as changes in business model and therefore do not warrant reclassification. The Basel III norms[24] also place restrictions on moving instruments between the regulatory books (i.e., trading book to banking book) stating *"that switching should be rare and will be allowed by supervisors only in extraordinary circumstances"*. However, in India, apart from the annual reclassification with the approval of the Board, banks have also been allowed special dispensations by the RBI to reclassify their investment portfolios. Periodical regulatory dispensations such as spreading over provisioning requirements or reclassification between categories to ease the interest rate risk of banks is not desirable from the point of view of efficient price discovery in the G-Sec market and effective market discipline on the G-Sec issuer. Further, if the intent based on which securities are classified and measured initially undergo frequent changes as per the will of the entities, the

[24] Paragraph 25.14 of BCBS – Minimum Capital Requirements for Market Risk (rev Feb 2019) Available at: https://www.bis.org/bcbs/publ/d457.pdf

premise underlying the accounting treatment is invalidated. Therefore, there is a strong case for prohibiting reclassification of investments between measurement categories. Apart from smoother transition to global best practices, it would help banks develop their systems to manage interest rate risk with the concomitant benefit of giving depth to the market for interest rate hedging instruments.

Proposal (4)

7.18. In consonance with the global standards and practices, it is proposed that re-classification between measurement categories should be prohibited. At the time of transition, the banks shall be allowed a one-time option to re-classify their financial instruments, after which no further re-classification/ shifting shall be allowed. Net gains/ losses on such transition shall be adjusted in the reserves.

Limit on holdings in HTM and Sales out of HTM

7.19. The rationale for a limit on the HTM category as derived from the Report of the Informal Group referred to earlier was two-fold viz. prudential and market driven. While the disclosure norms would address the prudential concerns relating to transparency, there is a concern that in the absence of limit, banks may resort to placing a disproportionately large proportion of their portfolio in the HTM category thereby reducing the volume of trading in the government securities market. However, rather than imposing a ceiling on holdings in HTM per se, sale of investments in HTM before maturity could be discouraged thereby requiring banks to consider securities being placed under HTM. This could be through (i) disallowing any gains arising from such sales as dividend and (ii) imposing a threshold on such sales beyond which supervisory approval shall be required.

Proposal (5)

7.20. The limit on investments in HTM as a percentage to total investments/SLR investments in HTM shall be dispensed with. Banks shall have a Board approved policy for sales out of HTM. In a given financial year the aggregate sales out of HTM shall not exceed 5 per cent of the opening carrying value of the HTM portfolio. Any sale beyond this threshold shall require prior supervisory approval from the Reserve Bank of India. However, sales to RBI under pre-announced open market operations (OMO) auctions, repurchase of Government Securities, etc. which are presently exempt from disclosure requirements, shall

continue to be exempt from this threshold limits. Further, sale/ disinvestment of subsidiaries, associates and joint ventures shall also be exempt from the threshold limits. As hitherto, any gains arising from sales out of HTM shall be transferred to a ‘Capital Reserve’, which shall not be available for distribution of dividend.

Non-SLR investments in HTM

7.21. Accounting should reflect the realisability of a financial asset on a going concern basis. Therefore, if a bank is holding a debt instrument with the intention of holding it to maturity (thereby locking in its yield) it should be reflected at amortised cost (i.e., HTM) irrespective of the issuer of the instrument[25].

Proposal (6)

7.22. Non-SLR securities shall be permitted to be held in HTM if they otherwise satisfy the conditions for classification as HTM.

Valuation

7.23. Global standards provide for a symmetric approach to recognition of unrealised gains and losses arising on changes in the fair valuation of financial instruments. In line with this, Proposal 3 provides for recognition of unrealised gains and losses directly in reserves for securities under AFS category and in Profit and Loss Account for securities in FVTPL category. While recognition of unrealised gains may be reasonable where there are deep and active markets for securities, it could be a matter of regulatory concern where the valuations are not based on market inputs, as for instance, in the case of unquoted equity shares.

7.24. The issues arising due to valuation methods are addressed to some extent through disclosure requirements according to source of inputs used for the valuation.

7.25. The concern that banks may give away unrealised gains as dividends is addressed through the Companies Act, 2013 (applicable to private sector banks) which precludes the payment of dividend from unrealised gains (Section 123). However, the issue remains for PSBs and the challenge is that the term

[25] It is possible that banks may be investing in high coupon bonds or debt instruments and wanting to hold it in HTM which is presently not possible given the restrictions in place.

"unrealised" has not been defined either in the accounting standards or in the Companies Act, 2013.

7.26. Unrealised gains, if allowed, qualify for CET 1 in Basel III unless prudential filters are applied by RBI. There is a concern if unrealised gains arising from unquoted instruments valued without market corroborated inputs qualify for CET 1.

Proposal (7)

7.27. Banks shall use quoted prices and market-based inputs (yield curves, credit spreads, etc.) for valuation wherever available. Banks shall categorise their investments into three fair value hierarchies (viz. Level 1, Level 2 and Level 3) based on inputs to the valuation. At the top, i.e. Level 1, shall be investments which are valued using quoted prices (unadjusted) in active markets that the bank can access. At the next level, i.e. Level 2, shall be investments (other than Level 1), that are valued using observable inputs such as yield curves, credit spreads, etc. At the lowest shall be Level 3 where investments have been valued using unobservable inputs. Illustratively, a benchmark Government Security valued using the market quote would be Level 1, a listed but not actively traded corporate bond priced using the government securities yield curve with a credit spread would be Level 2 while an unquoted equity share would be Level 3. Banks shall be required to disclose, in their notes to accounts, the fair values of AFS and FVTPL assets categorised as Level 1, Level 2, and Level 3.

7.28. Banks shall be prohibited from paying dividends out of gross gains recognised in the Profit and Loss Account arising on fair valuation of Level 3 assets that remain on their Balance Sheet (as at balance sheet date). Unrealised gains on Level 3 assets should be reduced from net profits available for distribution as well as from regulatory capital.

7.29. An 'active market', in this context, is defined as a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis. Inter-bank foreign exchange markets, the domestic Central Government Securities Market for benchmark securities, recognised stock exchanges for SENSEX/ NIFTY shares shall be considered as active markets.

Question 6: Is the definition of 'active market' as given above with illustrative examples adequate? Are there any other markets that could be considered as 'active markets'? Comments may be provided with rationale.

7.30. Unobservable inputs, in this context, are those for which market data such as quoted prices or yield curves are not available and are instead based on assumptions. The valuation of the following investments shall be presumed to be based on the unobservable inputs and classified under Level 3, unless the bank can satisfy the RBI supervision team and its auditors to the contrary.

(a) Unquoted equity shares and mutual funds that invest more than 10 per cent of their corpus in unquoted instruments.

(b) Securitisation receipts.

(c) Investments in a securitisation transaction such as pass through certificates and other instruments that represent an interest in underlying loans and receivables.

(d) Units of Alternative Investment Funds, Real Estate Investment Trusts, Infrastructure Investment Trusts, etc. and other such investment vehicles that invest primarily in unlisted securities.

Question 7: Is the definition of 'unobservable inputs' as given above with illustrative examples adequate?

Investment Reserve Account (IRA) and Investment Fluctuation Reserve (IFR)

7.31. As per extant instructions, excess provisions (provisions held less required in a year) on account of depreciation in the 'AFS' or 'HFT' categories should be appropriated to an IRA (eligible for inclusion under Tier 2 capital). Further, banks have also been advised to create an IFR (qualifying for Tier 2 capital treatment) to address the systemic impact of sharp increase in yields in government securities.

7.32. By precluding the payment of dividends from unrealised gains on fair valuation of financial instruments, exclusion of unrealised gains on Level 3 assets from regulatory capital coupled with a proposed capital charge for market risk in Basel

III, specific reserves such as IRA and IFR may not be required. However, given the experience of RBI having to provide special dispensations on occasions when the interest rate cycle has turned upwards, there may be merit in following a prudent approach.

Proposal (8)

7.33. It is proposed that while IRA be discontinued, IFR shall continue and be recalibrated to a certain percentage of the AFS and FVTPL portfolio over a phased period of say three years. IFR shall be allowed as Tier 2 Capital. The balance in IRA shall be transferred to any reserve under "Revenue and Other Reserves" which is reckoned for CET 1.

Question 8: Should the IFR continue? If so at what level should it be set and how much time should be given to banks to achieve that level?

Disclosures

7.34. Disclosures are intended to facilitate an evaluation of the significance of the financial instruments in the entities financial position and performance as well as of the risks emanating therefrom. Disclosures counterbalance the management discretion provided by promoting market discipline and review by a wide range of stakeholders.

Proposal (9)

7.35. Banks shall be required to disclose in the notes to accounts in the financial statements the following:

(a) Carrying amounts and fair value of each of the categories (i.e., HTM, AFS, FVTPL) and each class (i.e., Government securities, Other Approved Securities, Shares, Debentures and Bonds, Subsidiaries, Associates and/ or joint ventures, others).

(b) Gain/loss for each category of investments that has been recognised in the Statement of Profit or Loss or in the AFS- Reserve.

(c) Disclosures as per fair value hierarchy.

(i) For fair valuation measurements categorised as Level 2 and Level 3, the valuation method, inputs and relevant assumptions to compute the fair value and any change in the valuation technique along with reasons thereof.

(ii) For fair value measurement categorised as Level 3, quantitative information about significant unobservable inputs used in the fair value measurement.

(d) Disclose, if fair value cannot be determined.

Derivatives

7.36. The asymmetric treatment of fair value gains and losses in the investment portfolio and the absence of a comprehensive guidance on the accounting of derivatives especially hedge accounting may have attenuated the development of interest rate and credit derivative markets. While the previous recommendations address the issue of symmetric treatment, there is a need for clarity on the accounting treatment for derivatives for entities that are not under Ind AS. The ICAI has issued a 'Guidance Note on Accounting for Derivative Contracts' (Revised 2021). However, the presentation requirements requiring derivatives to be presented as current and non-current may not be consistent with the formats of the financial statements for banks prescribed under the Third Schedule to the BR Act.

Proposal (10)

7.37. The ICAI may consider updating its Guidance Note to provide consistency with the presentation framework of banks and banks shall be mandated to comply with the requirements of the ICAI guidance note.

Limits on investments in unlisted securities

7.38. As per clause 12(ii)(a) of the Reserve Bank of India (Classification, Valuation and Operation of Investment Portfolio of Commercial Banks) Directions, 2021, a

ceiling[26] is placed on bank's investment in unlisted non-SLR securities. It is possible that after listing a security may subsequently become unlisted and cause a breach in the ceiling on unlisted investments.

Proposal (11)

7.39. Instances where an investment was originally listed but subsequently unlisted shall be exempted from the 10 per cent requirement of unlisted investments because such breaches are involuntary and banks face constraints in disposing off such investments. However, banks shall separately track these investments and formulate a strategy for their disposal which should be subjected to annual review by the Board of Directors.

Withdrawal of outdated instructions

7.40. With the introduction of electronic anonymous order matching systems like NDS-OM, the instructions pertaining to engagement of brokers have become outdated.

Proposal (12)

7.41. It is proposed that the requirements for engagement of brokers shall be reviewed for its relevance in view of the updated technology and financial market developments.

8. Transition

8.1. It is proposed to make the revised framework applicable with effect from April 1, 2023. As a part of the transition:

(a) Banks shall reclassify their portfolio as per the revised framework.

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[26] As per extant instructions, bank's investment in unlisted non-SLR securities should not exceed 10 per cent of its total investment in non-SLR securities as on March 31, of the previous year. In case such investments included under unlisted non-SLR securities lead to a breach of the 10 per cent limit, the bank would not be allowed to make further investment in non-SLR securities (both primary and secondary market) as also in unrated bonds issued by companies engaged in infrastructure activities till such time bank's investment in unlisted non-SLR securities comes within the limit of 10 per cent.

(b) Investments that are presently held under HTM and are proposed to continue under HTM shall continue to be held at cost. Banks shall recognise any discount not recognised thereon in the Reserves and Surplus.

(c) All other investments shall be marked to market as at April 1, 2023 and any consequent gain/ loss on such fair valuation shall be directly adjusted in Reserves and Surplus without requiring RBI permission.

(d) Banks shall inform the Department of Supervision, RBI of the extent of adjustment made to Reserves and Surplus consequent to the transition to the revised norms within 21 days of making such adjustment. Details of the same shall also be disclosed in the Notes to the Financial Statements for year ending March 31, 2024.

Question 9: Do you agree with the implementation time frame and transitional adjustments?

Question 10: Are there any proposals you do not agree with? If yes, please provide separate comments for each proposal you do not fully agree with mentioning the proposal number, the specific paragraph number and reasons for disagreement. Comments would be useful, if they clearly articulate implementation difficulties or conceptual issues along with alternative proposals.