Guidelines for Classification and Valuation of Investments by banks

October 16, 2000

DBOD.No.BP.BC. 32 / 21.04.048/ 2000-2001

All Commercial Banks
(excluding RRBs and LABs)

Dear Sirs,

Guidelines for Classification and Valuation of Investments by banks

Please refer to paragraph 44 (b) of the Statement on 'Mid-term Review of Monetary and Credit Policy for the year 2000-2001' enclosed to Governor's letter MPD.No.BC.201/07010279/2000-2001 dated October 10, 2000.

2.1 At present, investments of banks comprise SLR securities and non-SLR securities. The classification of the investments in the balance sheet, for disclosure, is under six groups viz., i) Government securities ii) Other approved securities iii) Shares iv) Debentures & Bonds v) Subsidiaries/ joint ventures vi) Others (CP, Mutual Fund Units, etc.). While the first two classifications represent the banks' investments in SLR securities the other four represent the non-SLR securities. Banks were earlier advised that for the purpose of valuation,

a) the investments of banks in SLR securities should be bifurcated into 'current' and 'permanent', with the prescription that the 'current' investments are not less than 75% of the total SLR securities, excluding the new banks set up after 1993 in the private sector which were required to include their entire SLR investments under 'current' category and

b) 'current' category of SLR investments and the entire portfolio of non-SLR investments should be marked to market.

2.2 RBI has also been issuing detailed guidelines to be followed for valuation of the investments and marking them to market every year. Besides, to facilitate valuation of investments which are not quoted, YTM rates for Government securities of different maturities, as on March 31, are also being issued annually.

Review

3. With the introduction of prudential norms on capital adequacy, income recognition, asset classification and provisioning requirements the financial position of banks in India has improved in the last few years. Simultaneously, trading in the securities market has improved in terms of turnover and the range of maturities dealt with. In view of these developments and taking into consideration the evolving international practices, an Informal Working Group in the Bank has reviewed the existing instructions on the classification and valuation of the investments portfolio. The guidelines on classification and valuation of investments by banks have been revised on the

basis of the recommendations of the Informal Group to bring them in consonance with the best international practices.

Revised Guidelines

4.1 The highlights of the revised guidelines are given below:

- The revised guidelines furnished in the Annexure will be effective from the half-year ended September 30, 2000.
- The banks are required to classify their entire investment portfolio as on September 30, 2000, under three categories viz. ‘Held to Maturity’, ‘Available for Sale’ and ‘Held for Trading’.
- In the balance sheet, the investments will continue to be disclosed as per the existing six classifications viz. i) Government securities ii)other approved securities iii) Shares iv) Debentures & Bonds v) Subsidiaries/ joint ventures vi) Others (CP, Mutual Fund Units, etc.).
- The investments under the Available for Sale and Held for Trading categories should be marked to market periodically as indicated in the Annexure or at more frequent intervals.
- The investments under the Held to Maturity category need not be marked to market as in the case of ‘Permanent’ securities at present.
- Classification of investments, shifting of investments among the three categories, valuation of the investments, methodology for booking profit/ loss on sale of investments and providing for depreciation should be in accordance with the guidelines in the Annexure.
- The risk-weights assigned to the various securities at present, including those for ‘market risk’, would remain unchanged.

4.2 The classification of the existing investments among the three categories may be done at the book value of the respective securities as on September 30, 2000. Subsequent valuation of the securities included under the ‘Held for Trading’ and the ‘Available for Sale’ categories may be carried out as specified in the revised guidelines. The first such revaluation may be done as on September 30, 2000 for the securities under the ‘Held for Trading’ category. Securities under the ‘Available for Sale’ category may also be revalued as on that date if the bank proposes to revalue this category at intervals more frequent than ‘annual’ intervals.

4.3 Banks should formulate an Investment Policy with the approval of their Board of Directors to take care of the requirements on classification, shifting and valuation of investments under the revised guidelines. Besides, the Policy should adequately address risk-management aspects, ensure that the procedures to be adopted by the banks under the revised guidelines are consistent, transparent and well documented to facilitate easy verification by inspectors and statutory auditors.

Yours faithfully

Sd/-
(A.Ghosh)
Chief General Manager-in-Charge

ANNEXURE
Guidelines for Classification and Valuation of Investments by banks

A. Categorisation:

1. The entire investment portfolio of the banks (including SLR securities and non-SLR securities) will be classified under three categories viz. ‘Held to Maturity’, ‘Available for Sale’ and ‘Held for Trading’. However, in the balance sheet, the investments will continue to be disclosed as per the existing six classifications viz. i) Government securities ii) Other approved securities iii) Shares iv) Debentures & Bonds v) Subsidiaries/ joint ventures vi) Others (CP, Mutual Fund Units, etc.).

[Definitions: The securities acquired by the banks with the intention to hold them up to maturity will be classified under Held to Maturity. The securities acquired by the banks with the intention to trade by taking advantage of the short-term price/ interest rate movements will be classified under Held for Trading. The securities which do not fall within the above two categories will be classified under Available for Sale]

2. Banks should decide the category of the investment at the time of acquisition and the decision should be recorded on the investment proposals.

Held to Maturity
3. The investments included under “Held to Maturity” should not exceed 25 per cent of the bank’s total investments. The banks may include, at their discretion, under Held to Maturity category securities less than 25 per cent of total investment.

4. The following investments will be classified under ‘Held to Maturity’ but will not be counted for the purpose of ceiling of 25% specified for this category:

a) Re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in their investment portfolio. This will not include re-capitalisation bonds of other banks acquired for investment purposes.
b) Investment in subsidiaries and joint ventures. [A joint venture would be one in which the bank, along with its subsidiaries, holds more than 25% of the equity.]
c) The investments in debentures/ bonds, which are deemed to be in the nature of an advance.

Debentures/ bonds must be treated in the nature of an advance when:

- The debenture/bond is issued as part of the proposal for project finance and the tenure of the debenture is for a period of three years and above

or
The debenture/bond is issued as part of the proposal for working capital finance and the tenure of the debenture/ bond is less than a period of one year
and

- the bank has a significant stake i.e.10% or more in the issue

and

- the issue is part of a private placement, i.e. the borrower has approached the bank/FI and not part of a public issue where the bank/FI has subscribed in response to an invitation.

The debentures/ bonds deemed to be in the nature of advance will be subject to the usual prudential norms applicable to advances.

5. The banks, which had already marked to market more than 75% of their SLR portfolio, will be given the option to re-classify their investments under this category up to the permissible level.

6. Profit on sale of investments in this category should be first taken to the Profit & Loss Account and thereafter be appropriated to the ‘Capital Reserve Account’. Loss on sale will be recognised in the Profit & Loss Account.

Available for Sale & Held for Trading

7. The banks will have the freedom to decide on the extent of holdings under Available for Sale and Held for Trading categories. This will be decided by them after considering various aspects such as basis of intent, trading strategies, risk management capabilities, tax planning, manpower skills, capital position.

8. The investments classified under Held for Trading category would be those from which the bank expects to make a gain by the movement in the interest rates/ market rates. These securities are to be sold within 90 days. If the bank is not able to sell the security within 90 days due to exceptional circumstances such as tight liquidity conditions, or extreme volatility, or market becoming unidirectional, the security should be shifted to the Available for Sale category subject to items 12 and 13 below.

9. Profit or loss on sale of investments in both the categories will be taken to the Profit & Loss Account.

B. Shifting among categories:

10. Banks may shift investments to/from Held to Maturity category with the approval of the Board of Directors once a year. Such shifting will normally be allowed at the beginning of the accounting year. No further shifting to/from this category will be allowed during the remaining part of that accounting year.

11. Banks may shift investments from Available for Sale category to Held for Trading category with the approval of their Board of Directors/ ALCO/ Investment Committee. In case of exigencies, such shifting may be done with the approval of the Chief Executive of the bank/ Head of the ALCO, but should be ratified by the Board of Directors/ ALCO.

12. Shifting of investments from Held for Trading category to Available for Sale category is generally not allowed. However, it will be permitted only under exceptional circumstances as mentioned at item 8 above, subject to depreciation, if any, applicable on the date of transfer, with the approval of the Board of Directors/ ALCO/ Investment Committee.

13. Transfer of scrips 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 should be fully provided for.

C. Valuation

14. Investments classified under Held to Maturity category need not be marked to market and will be carried at acquisition cost unless it is more than the face value, in which case the premium should be amortised over the period remaining to maturity.

15. Banks should recognise any diminution, other than temporary, in the value of their investments in subsidiaries/ joint ventures which are included under Held to Maturity category and provide therefor. Such diminution should be determined and provided for each investment individually.

16. The individual scrips in the Available for Sale category will be marked to market at the year-end or at more frequent intervals. While the net depreciation under each classification referred to in item 1 above should be recognised and fully provided for as indicated in item 17 below, the net appreciation under each classification referred to in item 1 above should be ignored. The book value of the individual securities would not undergo any change after the revaluation.

[Note: Securities under this category shall be valued scrip-wise and depreciation/ appreciation shall be aggregated for each classification referred to in item 1 above. Net depreciation, if any, shall be provided for. Net appreciation, if any, should be ignored. Net depreciation required to be provided for in any one classification should not be reduced on account of net appreciation in any other classification.]

17. The provisions required to be created on account of depreciation in the Available for Sale category in any year should be debited to the Profit & Loss Account and an equivalent amount (net of tax benefit, if any, and net of consequent reduction in the transfer to Statutory Reserve) or the balance available in the Investment Fluctuation Reserve Account, whichever is less, shall be transferred from the Investment Fluctuation Reserve Account to the Profit & Loss Account. In the event provisions created on account of depreciation in the Available for Sale category are found to be in excess of the required amount in any year, the excess should be credited to the Profit & Loss Account and an equivalent amount (net of taxes, if any, and net of transfer to Statutory Reserves as applicable to such excess provision) should be appropriated to the Investment Fluctuation Reserve Account to be utilised to meet future depreciation requirement for investments in this category. The amounts debited to the Profit & Loss Account for provision and the amount credited to the Profit & Loss Account for reversal of excess provision should be debited and credited respectively under the head “Expenditure – Provisions & Contingencies”. The amounts appropriated from the Profit & Loss Account and the amount transferred from the Investment Fluctuation Reserve to the Profit & Loss Account should be shown as ‘below the line’ items after determining the profit for the year.

18. The individual scrips in the Held for Trading category will be revalued at monthly or at more frequent intervals and the net appreciation/ depreciation under each classification referred to in item 1 above will be recognised in the income account. The book value of the individual scrip will change with the revaluation.

General
19. In respect of securities included in any of the three categories where interest/ principal is in arrears, the banks should not reckon income on the securities and should also make appropriate provisions for the depreciation in the value of the investment. The banks should not set-off the depreciation requirement in respect of these non-performing securities against the appreciation in respect of other performing securities.

Market value
20. The 'market value' for the purpose of periodical valuation of investments included in the Available for Sale and the Held for Trading categories would be the market price of the scrip as available from the trades/ quotes on the stock exchanges, SGL account transactions, price list of RBI, prices declared by Primary Dealers Association of India (PDAI) jointly with the Fixed Income Money Market and Derivatives Association of India (FIMMDA) periodically. In respect of unquoted securities, the procedure as detailed below should be adopted.

Unquoted SLR securities
Central Government Securities
21. The Reserve Bank of India will not announce the YTM rates for unquoted Government securities, as hitherto, for the purpose of valuation of investments by banks. The banks should value the unquoted Central Government securities on the basis of the prices/ YTM rates put out by the PDAI/ FIMMDA at periodical intervals.

22. The 6.00 per cent Capital Indexed Bonds may be valued at "cost" as defined in circular DBOD. NO.BC.8/12.02.001 / 97-98 dated January 22, 1998 and BC.18/12.02.001/2000-2001 dated August 16, 2000.

23. Treasury Bills should be valued at carrying cost.

State Government Securities
24. State Government securities will be valued applying the YTM method by marking it up by 25 basis points above the yields of the Central Government Securities of equivalent maturity put out by PDAI/ FIMMDA periodically.

Other 'approved' Securities
25. Other approved securities will be valued applying the YTM method by marking it up by 25 basis points above the yields of the Central Government Securities of equivalent maturity put out by PDAI/ FIMMDA periodically.

Unquoted non-SLR securities
Debentures/ Bonds
26. All debentures/ bonds other than debentures/ bonds which are in the nature of advance should be valued on the YTM basis. Such debentures/ bonds may be of different companies having different ratings. These will be valued with appropriate mark-up over the YTM rates for Central Government securities as put out by PDAI/ FIMMDA periodically. The mark-up will be graded

according to the ratings assigned to the debentures/ bonds by the rating agencies subject to the following :-

(a) The rate used for the YTM for rated debentures/ bonds should be at least 50 basis points above the rate applicable to a Government of India loan of equivalent maturity.

(b) The rate used for the YTM for unrated debentures/ bonds should not be less than the rate applicable to rated debentures/ bonds of equivalent maturity. The mark-up for the unrated debentures/ bonds should appropriately reflect the credit risk borne by the bank.

(c) Where interest/ principal on the debenture/ bonds is in arrears, the provision should be made for the debentures as in the case of debentures/ bonds treated as advances. The depreciation/ provision requirement towards debentures where the interest is in arrears or principal is not paid as per due date, shall not be allowed to be set-off against appreciation against other debentures/ bonds.

Where the debenture/ bonds is quoted and there have been transactions within 15 days prior to the valuation date, the value adopted should not be higher than the rate at which the transaction is recorded on the stock exchange.

Preference Shares

27. The valuation of preference shares should be on YTM basis. The preference shares will be issued by companies with different ratings. These will be valued with appropriate mark-up over the YTM rates for Central Government securities put out by the PDAI/FIMMDA periodically. The mark-up will be graded according to the ratings assigned to the preference shares by the rating agencies subject to the following:

a) The YTM rate should not be lower than the coupon rate/ YTM for a GOI loan of equivalent maturity.

b) The rate used for the YTM for unrated preference shares should not be less than the rate applicable to rated preference shares of equivalent maturity. The mark-up for the unrated preference shares should appropriately reflect the credit risk borne by the bank.

c) Investments in preference shares as part of the project finance may be valued at par for a period of two years after commencement of production or five years after subscription whichever is earlier.

d) Where investment in preference shares is as part of rehabilitation, the YTM rate should not be lower than 1.5% above the coupon rate/ YTM for GOI loan of equivalent maturity.

e) Where preference dividends are in arrears, no credit should be taken for accrued dividends and the value determined on YTM should be discounted by at least 15% if arrears are for one year, and more if arrears are for more than one year. The depreciation/ provision requirement arrived at in the above manner in respect of non-performing shares where dividends are in arrears shall not be allowed to be set-off against appreciation on other performing preference shares.

f) The preference share should not be valued above its redemption value.

g) When a preference share has been traded on stock exchange within 15 days prior to the valuation date, the value should not be higher than the price at which the share was traded.

Equity Shares
28. Equity shares for which current quotations are not available or where the shares are not quoted on the stock exchanges, should be valued at break-up value (without considering 'revaluation reserves', if any) which is to be ascertained from the company's latest balance sheet (which should not be more than one year prior to the date of valuation). In case the latest balance sheet is not available the shares are to be valued at Re.1 per company.

Mutual Funds Units
29. Investment in quoted Mutual Fund Units should be valued as per Stock Exchange quotations. Investment in non-quoted Mutual Fund Units is to be valued on the basis of the latest re-purchase price declared by the Mutual Fund in respect of each particular Scheme. In case of funds with a lock-in period, where repurchase price/ market quote is not available, Units could be valued at NAV. If NAV is not available, then these could be valued at cost, till the end of the lock-in period. Wherever the re-purchase price is not available the Units could be valued at the NAV of the respective scheme.

Commercial Paper
30. Commercial paper should be valued at the carrying cost.

Investments in RRBs
31. Investment in RRBs is to be valued at Carrying Cost (i.e. book value) on consistent basis.