ANNEXURE

Guidelines for Classification and Valuation of Investments - Clarifications / Modifications

S. No.	Present norms of RBI	Suggestion / query	Clarification/ modification
1.	**Definition of Joint Ventures** Companies floated by the FI and in which the FI, along with the holdings, if any, by its subsidiaries, holds more than 25% of the equity share capital, would also be classified as a Joint Venture.	The investments in the equity shares of certain organisation such as SFCs, SIDCs, Technical Consultancy Organisations (TCOs), etc., which were **NOT floated by the FIs** but whose shares were transferred to them pursuant to certain **statutory amendments/ role assigned** to the FIs, should also be classified as investment in Joint Venture / Subsidiaries. (Such investments in certain case could also be in excess of 25% of equity capital of these organisations.)	A distinction ought to be made between the **transfer** of an investment and **transmission** of an investment to an FI on account of the operation of a statute. Thus, if the shares of a corporate entity were transmitted to an FI on account of operation of a statute, and were not acquired of its own volition, such entities could be treated as a Joint Venture and the shares held therein classified and valued accordingly, as per the extant RBI norms.
2(a)	**Treatment of preference shares** The preference shares, other than convertible preference shares, acquired as a part of project financing and meeting the extant criteria for treating the bonds and debentures as 'in the nature of advance', should be treated as in the nature of advance and would not be counted for the purpose of 25% ceiling.	Whether the preference shares **acquired by conversion** of loans / debentures in the nature of advance (which were originally acquired as a part of project financing), would also be eligible to be categorised as in the nature of advance?	The preference shares acquired by conversion of loans / debentures which qualify as in the 'nature of advance' as per the extant criteria, should also be treated in the nature of advance and categorised and valued accordingly.

S. No.	Present norms of RBI	Suggestion / query	Clarification/ modification
2(b)	**Valuation of preference shares in the nature of <u>advance</u>** Such preference shares are to be valued by notionally extending to them the asset classification of the outstanding loans of the issuing company. In case of loans in the doubtful category, the preference shares held should be treated as an unsecured facility and fully provided for.	The valuation of preference shares in the nature of advance, by notionally extending to them the asset classification of the outstanding loans of the issuing company, will be possible only till the loans are outstanding. Thereafter, such preference shares should be valued at the acquisition cost / amortisation value, subject to permanent diminution, if any.	The preference shares acquired by conversion of loans / debentures in the nature of advance could be viewed as loan equivalent. Such shares would also carry an obligation of dividend payment. Hence, in cases where there was no loan outstanding against a borrower company which had issued the shares, the record of dividend receipt on the preference shares should be looked into to determine the asset classification of the preference shares, as per record of recovery. For the purpose of asset classification, the due date of dividend payment on preference shares should be reckoned as the date of the closing of annual accounts of the company concerned. Accordingly, if the dividend on preference shares is not received within 180 days from the date of closing of annual accounts of the issuing company, the shares should be treated as NPA and provided for accordingly.
2(c)	**Valuation of non-project related and redeemable <u>preference shares</u>** Preference shares other than those in the nature of advance, if kept in the HTM category, should be reckoned within the ceiling of 25% for the investments in the HTM category and valued at acquisition / amortised cost.	Whether the non-project related redeemable preference shares in the HTM category could be valued at acquisition cost / amortisation value, subject to provision for permanent diminution, if any, **regardless of** yield, tenor and receipt of dividend in time?	Such preference shares being eligible to be kept in the HTM category, within the 25% ceiling, could be valued at acquisition cost / amortised cost subject to provisioning for permanent diminution, if any, in value - for which **payment of dividend would also be a relevant factor.**

S. No.	Present norms of RBI	Suggestion / query	Clarification/ modification
3.	**Eligible investments in <u>HTM category</u>** Only debt securities and as an exception, equity in subsidiaries & joint ventures and preference shares are permitted for inclusion in the HTM category.	It is felt that the investment in the units of closed-ended schemes of mutual funds should also be included in the HTM category.	The investments in the units of closed-ended schemes of mutual funds could be included in the HTM category **only if** such units were **not listed** on the Stock Exchange – since, in that case these could not be sold off in the market at any point of time. Thus, the units of even closed-ended schemes of mutual funds, **if listed** on the Stock Exchange, should be placed in the AFS or HFT category.
4.	**Valuation of equity in the nature of advance in AFS <u>category</u>** The equity holdings in the nature of advance should be compulsorily placed in the AFS category and valued by notionally extending to them the asset classification of the outstanding loans of the issuing company and provision made accordingly. If the loans outstanding are in the doubtful category, the equity held is to be treated as an unsecured facility and fully provided for.	It is felt that the equity holding should be deemed to be in the nature of advance when: a) the equity shares are issued as a part of proposal for project finance; and b) **<u>FIs</u>** hold 10% or more of the **<u>total</u> equity capital** of the issuing company, on the date of last available balance sheet of the issuing company; (as equity shares issued by companies are normally *pari passu* in nature and the concept of holding 10% or more in the various issues may not be made applicable for equity shares); and	The equity shares should be considered to be in the nature of advances if the equity shares were issued as part of a proposal for project finance.

S. No.	Present norms of RBI	Suggestion / query	Clarification/ modification
		c) The equity shares of the company are **not listed** as on the date of the valuation by FI.	
		The valuation of equity shares in the nature of advance, by notionally extending to them the asset classification of the outstanding loans of the issuing company, will be possible only till the loans are outstanding. Thereafter, such equity shares would be valued at break up value (without considering revaluation reserves, if any) as ascertained from the company's latest balance sheet. The provision for depreciation in the value of equity shares in the nature of advance should be on the acquisition cost thereof as their break up value will not be relevant for valuation of such shares. In other words, the listed shares will continue to be valued at market prices and the concept of equity shares in the nature of advance will not be applicable in such cases i.e., equity shares would cease to be in the nature of advance once the equity capital of a company gets listed on the stock exchange.	The equity shares in the nature of advance, in cases where no loan against the company issuing the shares was outstanding, should be valued at market price, if listed and quoted, provided the latest market quotation was not more than 30 day-old as on the date of valuation. The market price in such cases should not be based on a solitary or small value transaction but on price observed in a reasonable volume transaction, between two independent parties in an arm's-length relationship. If such shares happen to be "thinly traded shares", they should be valued as per the extant norms. The unquoted equity shares or where current quotations are not available, should be valued at "break up" value (without considering revaluation reserves, if any) derived from the company's latest balance sheet. In case, the latest balance sheet is not available, the shares should be valued at Re. 1/- per company. For the purpose of deriving break up value, the balance sheet used should not be older than one year (21 months in respect of companies, which close their accounts on dates other than 31 March) from the date of valuation.

S. No.	Present norms of RBI	Suggestion / query	Clarification/ modification
5.	**Valuation of unquoted preference shares** The guidelines framed by FIMMDA for valuation of tax-free bonds should be followed for valuation of unquoted preference shares, other than those in the HTM category, as follows: a) gross up the nominal dividend rate by the marginal tax rate of the FI to get the cum-tax dividend rate; b) Add the applicable credit spread / risk premium (as per the rating of the preference share) to the YTM for GOI security of equal residual maturity ; c) Use the **higher of the two** rates at (a) and (b) above as the effective YTM for valuation of preference shares.	It is presumed that "marginal tax rate of the FI" means income tax rate applicable on the taxable income of FI, on the date of valuation of investments. In case only higher of the two rates is to be applied for discounting the inflows, then the valuation would always be lower than the redemption value. Vide clarification in para no. 8(b), it has been clarified that unquoted preference shares should be valued strictly on YTM basis even if such valuation results in a higher value than the redemption value. So, it is felt that the stipulation to use the higher of the two rates may not be made applicable.	The marginal tax rate of an FI should be construed to mean the nominal income-tax rate that would have been applicable to it on its taxable income in the financial year to which the valuation pertains, even though the FI might have incurred a loss during the year and may not have any tax liability (i.e. '0' tax rate). However, in view of the change in the tax laws for the current financial year, the marginal tax rate would no longer be relevant. In view of the changes in the tax treatment of the dividend income in the Finance Act, 2002 (which now permits offsetting of the dividend inflows against the dividend outflows for tax purposes), the adjustment in YTM for the tax free nature of dividend on preference shares would not be necessary. The valuation methodology for the unquoted preference shares would, therefore, stand modified as follows: a) Determine the YTM of the preference shares as per its cash flow profile; b) Determine the YTM for GOI security of equal residual maturity and add the applicable credit spread / risk premium ,as per the rating of the preference share; (in case of **unrated preference shares**, the aforesaid credit spread / risk premium should be determined as per the extant norms detailed in our Circular No. C-6 dated October 16, 2001); c) Value the preference share as per the following formula: $\dfrac{\text{(YTM of the preference share)}}{\text{(rate arrived at step (b) above)}} \times 100$

S. No.	Present norms of RBI	Suggestion / query	Clarification/ modification