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The CEOs of the all-India Term Lending and Refinancing Institutions

Dear Sir,

Master Circular – Prudential norms for classification, valuation and operation of investment portfolio by FIs

As you are aware, the Reserve Bank of India has from time to time, issued a number of circulars to the FIs containing instructions on matters relating to Prudential norms for classification, valuation and operation of investment portfolio by FIs . In order to enable the FIs to have all the current instructions on the subject at one place, this master circular has been prepared.

2. It may be noted that the instructions contained in circulars listed in Part A of the Appendix have been consolidated in this master circular.

Yours faithfully,

(S.S. Gangopadhyay)
Chief General Manager

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MASTER CIRCULAR – PRUDENTIAL NORMS FOR CLASSIFICATION, VALUATION AND OPERATION OF INVESTMENT PORTFOLIO BY FIS

1. INTRODUCTION

The Committee appointed by the Governor, Reserve Bank of India to enquire into the securities transactions of banks and financial institutions (Janakiraman Committee) had, in its first report, brought out several serious irregularities in these transactions. As one of the follow-up measures, the RBI had issued a detailed circular to commercial banks for suitably regulating the transactions in their investment portfolio. A copy of the Circular had also been forwarded to the FIs for implementing the specific prohibitions and general instructions / guidelines suitably, to the extent applicable. Some of these prohibitions / restrictions since stand removed / relaxed. In view of the market developments and taking into consideration the evolving international practices, Reserve Bank of India has issued guidelines on classification, valuation and operation of investment portfolio by FIs from time to time as detailed below.

2. INVESTMENT POLICY

2.1 FIs have been undertaking transactions in securities on their own Investment Account, on behalf of Portfolio Management Scheme (PMS) clients in their fiduciary capacity, and on behalf of other clients, either as custodians of their investments or purely as their agents. With the approval of their respective Boards, FIs should clearly lay down the broad investment objectives to be followed while undertaking transactions in securities under each category mentioned above, clearly define the authority to put through deals, procedure to be followed for obtaining the sanction of the appropriate authority, procedure to be followed while putting through deals, various prudential exposure limits, and the reporting system. While laying down such investment policy guidelines, FIs should strictly observe the following instructions.

2.2 Ready Forward Contracts

The terms and conditions subject to which ready forward contracts (including reverse ready forward contracts) may be entered into will be as enumerated below. These terms and conditions will be the relevant terms and conditions specified by the RBI under its Notification No.S.O. 131(E) dated January 22, 2003 issued in exercise of powers conferred on the RBI under Section 16 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) *vide* Government of India Notification No. 183(E)

dated March 1, 2000, issued under Section 29A of the Act, *ibid*.

2.2.1 Eligibility

(a) Ready forward contracts may be undertaken only in:

i) dated securities and Treasury Bills issued by Government of India; and

ii) dated securities issued by the State Governments.

(b) Ready forward contracts in the above mentioned securities may be entered into by:

(i) persons or entities maintaining a Subsidiary General Ledger (SGL) account with the Reserve Bank of India, Mumbai; and

(ii) the following category of entities which do not maintain SGL accounts with the Reserve Bank of India but maintain gilt accounts (i.e. gilt account holders) with a bank or any other entity (i.e. the custodian) permitted by the Reserve Bank of India to maintain Constituent Subsidiary General Ledger Account (CSGL Account) with its Public Debt Office, Mumbai:

1. Any scheduled bank,
2. Any primary dealer authorised by the Reserve Bank of India,
3. Any non-banking financial company registered with the Reserve Bank of India, other than Government companies as defined in section 617 of the Companies Act, 1956,
4. Any mutual fund registered with the Securities and Exchange Board of India,
5. Any housing finance company registered with the National Housing Bank, and
6. Any insurance company registered with the Insurance Regulatory Development Authority.

2.2.2 Restrictions

(c) All persons or entities specified at (b) above can enter into ready forward transactions among themselves subject to the following restrictions:

i) An SGL account holder may not enter into a ready forward contract with its own constituent. That is, ready forward contracts should not be undertaken between a custodian and its gilt account holder.

(ii) Any two gilt account holders maintaining their gilt accounts with the same custodian (i.e., the CSGL account holder) may not enter into ready forward contracts with each other, and

(iii) Cooperative banks may not enter into ready forward contracts with the non-banking financial companies.

2.2.3 Other Requirements

(d) All ready forward contracts shall be reported on the Negotiated Dealing System (NDS). In respect of ready forward contracts involving gilt account holders, the custodian (i.e., the CSGL account holder) with whom the gilt accounts are maintained will be responsible for reporting the deals on the NDS on behalf of the constituents (i.e. the gilt account holders).

(e) All ready forward contracts shall be settled through the SGL Account/CSGL Account maintained with the Reserve Bank of India, Mumbai, with the Clearing Corporation of India Ltd. (CCIL) acting as the central counter party for all such Ready Forward transactions.

(f) The custodians should put in place an effective system of internal control and concurrent audit to ensure that: (i) ready forward transactions are undertaken only against the clear balance of securities in the gilt account, (ii) all such transactions are promptly reported on the NDS, and (iii) other terms and conditions referred to above have been complied with.

(g) The RBI regulated entities can undertake ready forward transactions only in securities held in excess of the prescribed Statutory Liquidity Ratio (SLR) requirements.

(h) No sale transaction shall be put through without actually holding the securities in the portfolio by a seller of securities in the first leg of a ready forward transaction.

(i) Securities purchased under the ready forward contracts shall not be sold during the period of the contract.

2.3 <u>Transaction / trading in Government Securities</u>

The following instructions should be followed in conducting the trade in Government securities:

A. Transactions through SGL account

2.3.1 For purchase/ sale of securities through SGL A/c under the Delivery Versus Payment (DVP) System wherein the transfer of securities takes place simultaneously with the transfer of funds, it is necessary for both the selling and the buying entities to maintain current account with the RBI. As no overdraft facility in the current account would be extended, adequate balance in current account should be maintained by the

FIs for effecting any purchase transaction. The following instructions should be followed by the FIs:

i) All transactions in Govt. securities for which SGL facility is available should be put through SGL A/cs only.

ii) Under no circumstances, a SGL transfer form issued by a FI in favour of another entity should bounce for want of sufficient balance of securities in the SGL A/c of seller or for want of sufficient balance of funds in the current a/c of the buyer.

iii) The SGL transfer form received by purchasing FIs should be deposited in their SGL A/cs. immediately i.e. the date of lodgement of the SGL transfer form with RBI shall be within one working day after the date of signing of the Transfer Form. While in cases of over the counter (OTC) trades, the settlement has to be only on 'spot' delivery basis as per Section 2(i) of the Securities Contract (Regulation) Act, 1956, in cases of deals on the recognised Stock Exchanges, settlement should be within the delivery period as per their rules, bye laws and regulations. In all cases, participants must indicate the deal/trade/contract date in Part C of the SGL form under 'Sale date'. Where this is not completed the SGL Form will not be accepted by the Reserve Bank of India (RBI).

iv) No sale should be effected by way of return of SGL form held by the FI.

v) SGL transfer forms should be signed by two authorised officials of the FI whose signatures should be recorded with the respective PDOs of the Reserve Bank and other banks / FIs.

vi) The SGL transfer forms should be in the standard format prescribed by the Reserve Bank and printed on semi-security paper of uniform size. They should be serially numbered and there should be a control system in place to account for each SGL form.

vii) If a SGL transfer form bounces for want of sufficient balance in the SGL A/c, the (selling) FI which has issued the form will be liable to the following penal action against it :

a) The amount of the SGL form (cost of purchase paid by the purchaser of the security) would be debited immediately to the current account of the selling FI with the Reserve Bank.

b) In the event of an overdraft arising in the current account following such a debit, penal interest would be charged by the Reserve Bank on the amount of the overdraft at a rate of three percentage points above the Discount and Finance House of India's (DFHI) call money lending rate on the day in question. However, if the DFHI's closing call money rate is lower than the prime lending rate of the FI, the applicable penal rate to be charged will be three percentage points above the prime lending rate of the FI concerned.

c) If the bouncing of the SGL form occurs thrice, the FI will be debarred from trading with the use of the SGL facility for a period of six months from the occurrence of the third bouncing. If, after restoration of the facility, any SGL form of the concerned FI bounces again, the FI will be permanently debarred from the use of the SGL facility in all the PDOs of the Reserve Bank.

d) The bouncing on account of insufficient balance in the current account of the buying FI would be reckoned (against the buying FI concerned) for the purpose of debarment from the use of SGL facility on par with the bouncing on account of insufficient balance in SGL a/c. of the selling FI (against selling FI). Instances of bouncing in both the accounts (i.e., SGL a/c and current a/c) will be reckoned together against the SGL account holder concerned for the purpose of debarment (i.e., three in a half-year for temporary suspension and any bouncing after restoration of SGL facility, for permanent debarment.)

2.3.2 In the light of certain fraudulent transactions observed in the guise of Government securities transactions in physical format by a few co-operative banks with the help of some broker entities, the following measures were announced in May 2002 for further reducing the scope for trading in physical form and the FIs were required to fully comply with these instructions by not later than July 31, 2003:

- All entities <u>regulated</u> by RBI [including financial institutions (FIs), primary dealers (PDs), cooperative banks, RRBs, local area banks (LABs), non banking financial companies (NBFCs)] should <u>*necessarily*</u> hold their investments in Government securities portfolio in either SGL (with RBI) or CSGL (with a scheduled commercial bank / State Cooperative Bank/PD/FI/sponsor bank (in case of RRBs)) and SHCIL or in a dematerialised account with depositories (NSDL/CDSL).

- Only one CSGL or dematerialised account can be opened by any such entity.

- In case the CSGL accounts are opened with a scheduled commercial bank or State Cooperative bank, the account holder has to open a designated funds account (for all CSGL related transactions) with the same bank.

- In case a CSGL account is opened with any of the non-banking institutions indicated above, the particulars of the designated funds account (with a bank) should be intimated to that institution.

- The entities maintaining the CSGL / designated funds accounts will be required to ensure availability of clear funds in the designated funds accounts for purchases and of sufficient securities in the CSGL account for sales before putting through the transactions.

- No further transactions by a regulated entity should be undertaken in physical form with any broker with immediate effect.

B. Transactions on Stock Exchanges

2.3.3 With a view to encouraging a wider participation of all classes of investors in the secondary market for government securities, the trading in Government of India dated securities at the stock exchanges though a nation-wide, anonymous, order-driven, screen-based system has been introduced with effect from January 16, 2003. The GoI securities can be traded on the automated systems of the National Stock Exchange (NSE); The Stock Exchange, Mumbai (BSE) and the Over The Counter Exchange of India (OTCEI). This Scheme is in addition to the present Negotiated Dealing System (NDS) of the RBI, which would continue to be in operation as hitherto.

2.3.4 In the trading system envisaged under the Scheme, the trades concluded on the exchanges will be cleared by their respective clearing corporations/ clearing houses; hence, the FIs will need to settle the trade either directly with the clearing corporations/ clearing houses (in case they are clearing members) or through a clearing member custodian. The FIs, as institutional investors, would be able to undertake the transactions only on the basis of making / receiving delivery.

2.3.5 With a view to facilitating participation of the FIs on the Stock Exchanges within the regulations prescribed by RBI, SEBI and the Exchanges, the FIs have been extended the following facilities:

a) The FIs may open demat accounts with a Depository Participant (DP) of National Securities Depositories Limited (NSDL)/ Central Depository Services Limited (CDSL) in addition to their SGL accounts with RBI. (So

far, the maintenance of demat account for the Government securities, except the SGL account, was not permissible for the FIs).

b) Value-free transfer of securities between SGL/CSGL and demat accounts would be enabled by PDO-Mumbai subject to operational guidelines being issued by our Department of Government and Bank Accounts (DGBA) separately. (Value-free transfer refers to the transfer of GOI securities from the SGL / CSGL account to the demat account of the same party - which, therefore, does not require payment of any consideration).

Operational Guidelines

2.3.6 While the FIs should continue to follow the guidelines, contained in this Master Circular, as amended from time to time, the FIs should ensure compliance with the following guidelines:

a) The FIs should obtain specific approval from their Board of Directors to enable them to trade in the Government securities on the stock exchanges;

b) The FIs should put in place enabling IT infrastructure, adequate risk management systems and appropriate internal control systems for the trading / settlement of government securities on stock exchanges. The back office arrangements should ensure that the trading on the NDS/OTC market and on the stock exchanges can be readily tracked for settlement / reconciliation purposes.

c) The trades done through any single broker will continue to be subject to the extant guidelines on dealings through brokers.

d) All trades should be settled either directly with clearing corporation / clearing house (in case they are clearing members) or else through clearing member custodians. Brokers / trading members shall not be involved in the settlement process.

e) At the time of trade, securities must be available with the FIs either in their SGL account with the RBI or in the demat account with the depositories. Any sale on (T+3) basis on the Stock Exchanges cannot be covered by a purchase on the NDS/OTC market [even on (T+0) basis] and subsequent transfer from SGL account to their demat account for effecting deliveries. Similarly, no sale is permitted on NDS/OTC on (T+0) basis against pay-in of securities expected on (T+0) on the Stock Exchanges.

f) The purchase transactions by the FIs should similarly be subject to availability of clear funds in their settlement accounts at the time of pay-in.

g) All payout of funds should invariably be out of clear funds, i.e. the payout must not be contingent upon the outcome of any clearing to be conducted on that day.

2.3.7 Any settlement failure on account of non-delivery of securities/ non-availability of clear funds will be treated as SGL bouncing and the current penalties in respect of SGL bouncing will be applicable. Stock Exchanges will report such failures to the respective Public Debt Offices.

2.3.8 The FIs should regularly report to their Audit Committee of the Board, the details of transaction in Government securities, on aggregate basis, undertaken on the Stock Exchanges and particulars of any "closed-out" transactions on the exchanges.

2.3.9 In this context, the attention of the FIs is drawn to the Scheme of Non-competitive Bidding available to the retail investors in the primary auctions of Government securities. A copy of the Scheme is furnished at **Annex I**. The maximum value limit of single non-competitive bid is rupees two crore (face value) in the auctions of the Government of India dated securities.

2.4 <u>Bank Receipts</u>

The following instructions should be followed in respect of the use of Bank receipts:

(i) No BR should be issued under any circumstances in respect of transactions in Government securities for which SGL facility is available. Even in the case of other securities, BR may be issued for ready transactions only, under the following circumstances:

(a) The scripts are yet to be issued by the issuer and the FI is holding the allotment advice.

(b) The security is physically held at a different centre and the bank/FI is in a position to physically transfer the security and give delivery thereof within a short period.

(c) The security has been lodged for transfer/interest payment and the FI is holding necessary records of such lodgements and will be in a position to give physical delivery of the security within a short period.

(ii) No BR should be issued on the basis of a BR (of another bank/FI) held by the bank and no transaction should take place on the basis of a mere exchange of BRs held by the bank/ FI.

(iii) BRs may be issued covering transactions relating to FIs' own Investment Accounts only, and no BR should be issued by FIs, covering transactions relating to either the Accounts of PMS Clients or Other Constituents' Account including brokers.

(iv) No BR should remain outstanding for more than 30 days.

(v) BRs should be issued on semi-security paper, in the standard format (prescribed by IBA), serially numbered, and signed by two authorised officials of the bank/FI, whose signatures are recorded with other banks. As in the case of SGL forms, there should be a control system in place to account for each BR form.

(vi) Separate registers of BRs issued and BRs received should be maintained, and arrangements should be put in place to ensure that these are systematically followed up and liquidated within the stipulated time limit.

2.5 Investments in Non-Government Debt Securities

2.5.1 Coverage

2.5.1.1 These guidelines **apply to** the FIs' investments in **debt instruments**, both in the primary market (public issue as also private placement) as well as the secondary market, in the following categories:

a) debt instruments issued by companies, banks, FIs and State and Central Government sponsored institutions, SPVs, etc.;

b) debt instruments/ bond issued by Central or State Public Sector Undertakings, with or without government guarantee;

c) units of debt-oriented schemes of Mutual Funds i.e., the schemes whose major part the corpus is invested in debt securities;

d) Capital gains bonds and the bonds eligible for priority sector status;

2.5.1.2 The guidelines, however, **do not apply to the following categories of investments** of the FIs:

a) government securities and the units of Gilt Funds;

b) securities which are in the nature of advance under the extant prudential norms of RBI;

c) units of the equity oriented schemes of Mutual Funds, viz., the schemes wherein **a major part** of their corpus is invested in equity shares;

d) units of the "Balanced Funds", which invest in debt as well as equities, **provided** a major part of the corpus is invested in equity shares. In case of predominance of investments in debt securities by the Fund, these guidelines would be attracted.

e) Units of venture capital funds and the money market mutual funds;

f) Commercial Paper; and

g) Certificates of Deposits

2.5.2 Effective date and transition time

While these guidelines would come into force with effect from April 1, 2004, considering the time required by the issuers of debt securities to get their existing unlisted debt issues listed on the stock exchanges, the following transition time is being provided:

a) Investment in units of mutual fund schemes where the entire corpus is invested in non-government debt securities would be outside the purview of the above guidelines **till December 31, 2004**; thereafter, such investments would also attract these guidelines.

b) With effect from January 1, 2005, investment in units of such schemes of mutual fund as have an exposure to unlisted debt securities of less than 10 per cent of the corpus of the scheme would be treated on par with listed securities for the purpose of the prudential limits prescribed at para 6 below. Thus, **till December 31, 2004**, investments in such units would attract the prudential limits.

c) The FIs may invest until March 31, 2004 in the existing **unlisted** securities, which were **issued on or before** November 30, 2003. In case, the issuers have applied to the stock exchange(s) for listing of such unlisted securities and the security is rated as minimum investment grade, the FIs may continue to invest in such unlisted securities even after March 31, 2004 but only until December 31, 2004.

d) As regards the unlisted securities **issued after** November 30, 2003, the FIs may invest, till December 31, 2004, up to 10 per cent of the incremental investments in the categories covered under these guidelines over the corresponding figure of outstanding investments as on November 30, 2003.

e) With effect from January 1, 2005 only those FIs would be eligible to make **fresh investments** (up to the prescribed prudential limits) in the unlisted securities covered in these guidelines whose investments in such securities are within the prudential limits prescribed.

2.5.3 Definitions

For the purpose of guidelines regarding investment in Non- Government debenture securities the following definitions would apply :

2.5.3.1 Rated security: A security will be treated as rated if it is subjected to a detailed rating exercise by an external rating agency in India which is registered with SEBI and is carrying a current or valid rating. The rating relied upon will be deemed to be current or valid if:

i) The credit rating letter relied upon is not more than one month old on the date of opening of the issue, and

ii) The rating rationale from the rating agency is not more than one year old on the date of opening of the issue, and

iii) The rating letter and the rating rationale are a part of the offer document.

iv) In the case of secondary market acquisition, the credit rating of the issue should be in force and confirmed from the monthly bulletin published by the respective rating agency.

2.5.3.2 <u>Unrated security</u>: Securities, which do not have a current or valid rating by an external rating agency, would be deemed as unrated securities.

2.5.3.3 <u>Listed debt security</u>: It is a security, which is listed on a stock exchange. If not so listed, it is an 'unlisted' debt security.

2.5.3.4 <u>Non performing investment</u> (NPI): An NPI (similar to a non performing advance (NPA) is one where:

i) In respect of fixed / predetermined income securities, interest / principal / fixed dividend on preference shares (including maturity proceeds) is due and remains unpaid for more than 180 days.

ii) The equity shares of a company have been valued at Re. 1/- per company, on account of the non-availability of the latest balance sheet (as per the instructions contained in para 26 of the Annexure to circular DBS.FID. No.C-9/01.02.00/ 2000-01 dated November 9, 2000)

iii) If any credit facility availed by the issuer of the security is classified as NPA in the books of the FI, investment in any of the securities issued by the same issuer would also be treated as NPI.

2.5.4 <u>Regulatory requirements</u>

2.5.4.1 The FIs must not invest in unrated debt securities but only in rated ones, which carry a minimum **investment grade rating** from a credit rating agency registered with SEBI.

2.5.4.2 The investment grade rating should have been awarded by an external rating agency, operating in India, as identified by the IBA/ FIMMDA. The list of such agencies would also be reviewed by IBA / FIMMDA at least once a year.

2.5.4.3 The FIs should not invest in debt securities of **original maturity** of less than one-year other than Commercial Paper and Certificates of Deposits, which are covered under the RBI guidelines.

2.5.4.4 **The FIs should undertake usual** due diligence **in respect of investments in debt securities including the securities which do not attract these guidelines.**

2.5.4.5 The FIs should ensure that all fresh investments in debt securities are made only in **listed debt securities** of companies, which comply with the requirements of the SEBI circular No. SEBI/MRD/SE/AT/36/2003/30/9 dated September 30, 2003, except to the extent indicated in paragraph 2.5.6 below.

2.5.4.6 The **unlisted debt securities** in which the FIs may invest up to the limits specified in paragraph 2.5.6 below, should be rated and disclosure requirements as prescribed by the SEBI for listed companies should be followed by the issuer company.

2.5.5 Internal assessments

Since the debt securities are very often a credit substitute, the FIs would be well advised to:

(i) subject all their investment proposals relating to debt securities to the same standards of credit appraisal as for their credit proposals, irrespective of the fact that the proposed investments may be in rated securities;

(ii) make their own internal credit analysis and assign internal rating even in respect of externally rated issues and not to rely solely on the ratings of external rating agencies; and

(iii) strengthen their internal rating systems which should also include building up of a system of regular (quarterly or half-yearly) tracking of the financial position of the issuer with a view to ensuring continuous monitoring of the rating migration of the issuers / issues.

2.5.6. Prudential limits

2.5.6.1 The total investment in the unlisted debt securities should **not exceed 10 per cent** of the FIs' total investment in debt securities, which fall within the ambit of these guidelines, as on March 31(June 30 in case of NHB), of the previous year. However, the investment in the following instruments will not be reckoned as 'unlisted debt securities' for monitoring compliance with the above prudential limits:

(i) Security Receipts (SRs) issued by Securitisation Companies / Reconstruction Companies registered with RBI in terms of the provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI) Act, 2002; and

(ii) Asset Backed Securities (ABS) and Mortgage Backed Securities (MBS) which are rated at or above the minimum investment grade.

2.5.6.2 The FIs which have exposure to investments in debt securities in excess of the prudential limit prescribed at para 6.1 above as on March 31, 2003 (June 30, 2003 in case of NHB) should not make any **fresh** investment in such securities till they ensure compliance with the above prudential limit.

2.5.6.3 As a matter of prudence, the FIs should stipulate, with the approval of the Board, minimum ratings / quality standards and industry-wise, maturity-wise, duration-wise, issuer-wise, etc., exposure limits, for acquiring exposure in debt securities, which fall within the ambit of these guidelines, to address the concentration risk and the risk of illiquidity.

2.5.7 Role of the Boards of Directors

2.5.7.1 The FIs should ensure that their investment policies, duly approved by the Board of Directors, are formulated duly taking into account all the relevant aspects specified in these guidelines. The FIs should put in place proper risk management systems for capturing and analysing the risk in respect of investment in debt securities and for taking timely remedial measures. The FIs should also put in place appropriate systems to ensure that investment in privately placed instruments is made in accordance with the systems and procedures prescribed under the FI's investment policy.

2.5.7.2 The Board should put in place a monitoring system to ensure that the prudential limits prescribed in paragraphs 2.5.6 above are scrupulously complied with, including the system for addressing the breaches, if any, due to rating migration.

2.5.7.3 Boards of the FIs should review, twice a year, the following aspects of investment in debt securities covered by these guidelines:

a) Total turnover (investment and divestment) during the reporting period;

b) Compliance with the RBI-mandated prudential limits as also those prescribed by the Board for such investments;

c) Rating migration of the issuers / securities held in the books of the FIs and consequent diminution in the portfolio quality; and

d) Extent of non-performing investments in the fixed income category.

2.5.8 <u>Reporting requirements</u>

2.5.8.1 In order to help in the creation of a central database on private placement of debt, the investing FIs should file a copy of all offer documents with the Credit Information Bureau (India) Ltd. (CIBIL). When the FIs themselves raise debt through private placement, they should also file a copy of the offer document with CIBIL.

2.5.8.2 Any default relating to payment of interest / repayment of instalment in respect of any privately placed debt should also be reported to CIBIL by the investing FIs along with a copy of the offer document.

2.5.8.3 The FIs should also report to the RBI such particulars in respect of their investments in unlisted securities as may be prescribed by RBI from time to time.

2.5.9 <u>Disclosures</u>

The FIs should disclose the details of the issuer composition of investments made through private placement and the non-performing investments in the 'Notes on Accounts' of the balance sheet, with effect from the year ending March 31, 2004 (June 30, 2004 in case of NHB) in the format furnished in **Annexure II**.

2.5.10 <u>Trading and settlement in debt securities</u>

As per the SEBI guidelines, all trades, with the exception of the spot transactions, in a listed debt security, shall be executed only on the trading platform of a stock exchange. In addition to complying with the SEBI guidelines, the FIs should ensure that all spot transactions in listed and unlisted debt securities are reported on the NDS and settled through the Clearing Corporation of India Limited (CCIL) from a date to be notified by RBI

3. INTERNAL CONTROL SYSTEM

3.1 The FIs should observe the following guidelines for internal control system in respect of investment transactions:

(i) There should be a clear functional separation of (a). trading, (b) settlement, monitoring and control and (c) accounting. Similarly, there should be a functional separation of trading and back office functions relating to FIs' own Investment Accounts, PMS Clients' Account and Other Constituents (including brokers') Accounts. While providing portfolio management service to their clients, the FIs should strictly comply with the following guidelines issued on the subject (vide DBOD. No. FSC. BC. 69/C. 469-90/91 dated 18 January 1991) and PMS Clients' Accounts should be subjected to a separate audit by external auditors:

(a) Only those FIs, which can provide such services on their own, should undertake the activity. Funds accepted for portfolio management from their clients, should not be entrusted to another bank / FI for management.

(b) 'PMS' should be in the nature of investment consultancy / management, for a fee, entirely at the customer's risk without guaranteeing, either directly or indirectly, a pre-determined return. The FI should charge definite fee for the services rendered independent of the return to the client.

(c) 'PMS' should be provided by FIs / their subsidiaries to their clients in respect of the latter's long term investable funds for enabling them to build up its portfolio of securities; in any case, the funds should not be accepted for portfolio management for a period less than one year. In the case of placement of funds for portfolio management by the same client on more than one occasion, on a continuous basis, each such placement should be treated as a separate account and each such placement should be for a minimum period of one year.

(d) The funds accepted for portfolio management, are essentially expected to be deployed in capital market instruments such as shares, debentures, bonds, securities, etc. In any case, portfolio funds should not be deployed for lending in call money / bills market, and lending to / placement with corporate bodies.

(e) The FI providing PMS to its clients should maintain client-wise account / record of funds accepted and investments made thereagainst, and all credits (including realised interest, dividend, etc.) and debits relating to the portfolio account should be put through such account. The tax deducted at source in respect of interest / dividend on securities held in the portfolio account should be reflected in the portfolio account. The account holder should be entitled to get a statement of his portfolio account.

(f) The FI’s own investments and investments belonging to the PMS clients should be kept distinct from each other. If there were any transactions between the FI’s investment account and portfolio account, they should be strictly at market rates. Though the FI could hold the securities belonging to the portfolio account in its own name on behalf of its PMS clients, there should be a clear indication that securities were held by it on behalf of ‘portfolio account’. Similarly, while putting through any transaction on behalf of a portfolio account, a clear indication should be given to the effect that the transaction pertained to the ‘portfolio account’.

(g) In the FI’s general ledger, a ‘Clients’ Portfolio Account’ should be maintained and all the funds received by it for portfolio management should be reflected in it on day-to-day basis. The FI’s liability to its clients in respect of funds accepted by it for portfolio management should be properly reflected in the published books of accounts of the FI/ its subsidiary.

(ii) For every transaction entered into, the trading desk should prepare a deal slip which should contain data relating to nature of the deal, name of the counterparty, whether it is a direct deal or through a broker, and if through a broker, name of the broker, details of security, amount, price, contract date and time. The deal slips should be serially numbered and controlled separately to ensure that each deal slip has been properly accounted for. Once the deal is concluded, the dealer should immediately pass on the deal slip to the back office for recording and processing. For each deal there must be a system of issue of confirmation to the counterparty. The timely receipt of requisite written confirmation from the counterparty, which must include all essential details of the contract should be monitored by the back office.

(iii) Once a deal has been concluded, there should not be any substitution of the counterparty bank/ FI by another bank/ FI by the broker, through whom the deal has been entered into; likewise, the security sold / purchased in the deal should not be substituted by another security.

(iv) On the basis of vouchers passed by the back office (which should be done after verification of actual contract notes received from the broker / counterparty and confirmation of the deal by the counterparty) the Accounts Section should independently write the books of accounts.

(v) In the case of transactions relating to PMS Client's Account (including brokers) all the relative records should give a clear indication that the transaction belongs to

PMS Clients & Other Constituents and does not belong to bank/ FIs' own Investment Account and the FI is acting only in its fiduciary / agency capacity.

(vi) Records of SGL transfer forms issued & received, should be maintained. Balances as per FI's books should be reconciled at quarterly intervals with the balances in the books of PDOs. If the number of transactions so warrant, the reconciliation should be undertaken more frequently, say on a monthly basis. The internal audit department shall also periodically check this reconciliation. Any bouncing of SGL transfer forms issued by selling bank/ FIs in favour of the buying bank/ FI, should immediately be brought to the notice of the Department of Banking Operations and Development (DBOD) of the RBI by the buying bank/ FI. Similarly, a record of BRs issued/received should be maintained. A system for verification of the authenticity of the BRs and SGL transfer forms received from other bank/ FIs and confirmation of authorised signatories should be put in place.

(vii) Bank/ FIs should put in place a reporting system to report to the top management on a weekly basis, the details of transactions in securities, details of bouncing of SGL transfer forms issued by other bank/ FIs and BRs outstanding for more than one month, and review of investment transactions undertaken during the period.

(viii) It is reiterated that bank/ FIs should not draw cheques on their account with RBI for third party transactions including inter-bank/ FI transactions. For such transactions, bankers' cheques / pay orders should be issued.

(ix) The Internal Audit Department should audit the transactions in securities on an ongoing basis and monitor compliance with the laid down management policies and prescribed procedures and report the deficiencies directly to the management of bank/ FIs.

3.2 Dealing through brokers

3.2.1 For engagement of brokers to deal in investment transactions, the FIs should observe the following guidelines:

(a) Transactions between one FI and another bank/FI should not be put through the brokers' accounts. The brokerage on the deal payable to the broker, if any (if the deal was put through with the help of a broker), should be clearly indicated on the notes/ memorandum put up to the top management seeking approval for putting through the transaction and separate account of brokerage paid, broker-wise, should be maintained.

(b) If a deal is put through with the help of a broker, the role of the broker should be restricted to that of bringing the two parties to the deal together.

(c) While negotiating the deal, the broker is not obliged to disclose the identity of the counterparty to the deal. On conclusion of the deal, he should disclose the counterparty and his contract note should clearly indicate the name of the counterparty.

(d) On the basis of the contract note disclosing the name of the counterparty, settlement of deals between banks / FIs, viz. both fund settlement and delivery of security, should be directly between the banks/ FIs and the broker should have no role to play in the process.

(e) With the approval of their top managements, FIs should prepare a panel of approved brokers, which should be reviewed annually, or more often if so warranted. Clear-cut criteria should be laid down for empanelment of brokers, including verification of their creditworthiness, market reputation, etc. A record of broker-wise details of deals put through and brokerage paid, should be maintained.

(f) A disproportionate part of the business should not be transacted through only one or a few brokers. FIs should fix aggregate contract limits for each of the approved brokers. A limit of 5% of total transactions (both purchase and sales) entered into by a FI during a year should be treated as the aggregate upper contract limit for each of the approved brokers. This limit should cover both the business initiated by a FI and the business offered/ brought to the FI by a broker. FIs should ensure that the transactions entered into through individual brokers during a year normally did not exceed this limit. However, if for any reason it becomes necessary to exceed the aggregate limit for any broker, the specific reasons therefor should be recorded, in writing, by the authority empowered to put through the deals. Further, the board should be informed of this, post facto.

(g) The concurrent auditors who audit the treasury operations should scrutinise the business done through brokers also and include it in their monthly report to the Chief Executive Officer of the FI. Besides, the business put through any individual broker or brokers in excess of the limit, with the reasons therefor, should be covered in the half-yearly review to the Board of Directors/ Local Advisory Board. These instructions also apply to subsidiaries and mutual funds of the FIs.

Exception: *The above norm of 5% would not be applicable to FIs dealings through Primary Dealers.*

3.2.2 Inter-bank securities transactions should be undertaken directly between banks / FIs and no FI should engage the services of any broker in such transactions.

Exception:

FIs may undertake securities transactions among themselves or with non-bank clients through members of the National Stock Exchange (NSE), OTC Exchange of India (OTCEI) and the Stock Exchange, Mumbai (BSE), where the transactions are more transparent. Transactions with non-bank clients, if such transactions are not undertaken on the NSE, OTCEI or BSE, should be undertaken by FIs directly, without use of brokers.

Although the Securities Contracts (Regulation) Act, 1956 defines the term `securities' to mean corporate shares, debentures, Govt. securities and rights or interest in securities, for the purpose of the aforesaid exception, the term `securities' would exclude corporate shares. Further, the Provident/ Pension Funds and Trusts registered under the Indian Trusts Act, 1882, will be outside the purview of the expression `non-bank clients' for the purpose of aforesaid exception.

3.3 Audit, review and reporting of investment transactions

3.3.1 The FIs should follow the following instructions in regard to audit, review and reporting of investment transactions:

a) FIs should undertake a half-yearly review (as of 30 September and 31 March) of their investment portfolio, which should, apart from other operational aspects of investment portfolio, clearly indicate and certify adherence to laid down internal investment policy and procedures and Reserve Bank guidelines, and put up the same before their respective Boards within a month, i.e., by end-April and end-October.

b) A copy of the review report put up to the FI's Board, should be forwarded to the Reserve Bank (concerned Regional Office of DBS) by 15 November and 15 May respectively. With effect from the half-year ended March 31, 2003 the half-yearly reviews of the investment portfolio of the FIs should be submitted to the Regional Offices of the Department of Banking Supervision (DBS), within whose jurisdiction the Head Office of the FI concerned is located, instead of being submitted to the Financial Institutions Division as hitherto.

c) In view of the possibility of abuse, treasury transactions should be separately subjected to a concurrent audit by internal auditors and the results of their audit should be placed before the CMD of the FI once every month. These audit reports should be sent to the Regional Office of Department of Banking Supervision (DBS) of the Reserve Bank under whose jurisdiction the Head Office of the FI falls. The major irregularities observed in the concurrent audit report of the treasury transactions as also the position of compliance therewith should be incorporated in the half-yearly reviews of the investment portfolio to be submitted to the Regional Offices of the DBS

3.4 Monitoring of subsidiaries / mutual funds

3.4.1 Over the years, financial institutions have diversified their activities into financial services such as merchant banking, venture capital, mutual funds, investment banking, housing finance, etc. and some others are in the process of doing so. Some financial institutions have set up subsidiaries or companies in which they have a significant stake, to carry out such activities. The parent FIs have considerable stake in the health of these institutions and any setback in their working could have an adverse effect on the parent FIs. It is therefore, important that the FIs should keep themselves informed about their activities and exercise adequate supervision over them.

3.4.2 While the parent FI has to maintain "arms length" distance from its subsidiaries/ mutual fund sponsored by it in regard to business parameters (such as taking undue advantage in borrowing/lending funds/ transferring/selling/buying of securities at rates other than market rates, giving special consideration for securities transactions, overindulgence in supporting/ financing the subsidiary, financing the bank's clients when the bank itself is not able or is not permitted to do so, etc.), it has to ensure that they operate in a healthy manner and in conformity with prudential requirements. The supervision by the parent FI should not, however, result in interference in the day to day management of the affairs of the subsidiary/ mutual fund. With this end in view, FIs should evolve such strategies as may be appropriate in this regard. Some important points in this context are indicated below:

(i) The Board of Directors of the parent /sponsor FI may review the working of the subsidiaries/mutual fund at periodical intervals (say, once in six months) covering the major aspects relating to their functioning and give proper guidelines/ suggestions for improvement, whenever considered necessary. Copies of such report along with the Board resolutions should be forwarded to RBI for information.

(ii) The parent FI may cause inspection/ audit of the books and accounts of the subsidiaries / mutual fund at periodical intervals, as appropriate, and ensure that the deficiencies noticed are rectified without lapse of time. If the FI feels that its own inspection staff is not adequately equipped to undertake the inspection / audit, the task may be entrusted to outside agencies like firms of Chartered Accountants. In case there is technical difficulty for causing inspection / audit (e.g. on account of non-existence of an enabling clause in the Memorandum and Articles of Association of the subsidiary or Asset Management company), steps may be taken to amend the same suitably.

(iii) In cases of mutual funds, monitoring may be done keeping in view the guidelines issued by the Securities and exchange Board of India (SEBI) from time-to-time.

(iv) Even in cases where the FIs have equity participation by way of portfolio investment in companies offering financial services, they may review the working of the latter at least on an annual basis and put up the review note to the Board. A copy of the review note together with the Board resolution should be sent to us for our information.

3.4.3 In some cases, the companies have been promoted jointly by FIs where each of them holds a substantial equity stake, though the promoted institution is not a subsidiary of any of the promoter financial institutions. In such cases, monitoring of the companies/ institutions may be carried out by a FI having the majority or the largest stake in the promoted company / institution. In the case of equal shareholding among the promoter FIs, a suitable arrangement for the purpose may be devised amongst the promoter institutions and we may be advised of the name of the parent institution/s entrusted with the responsibility of such supervision for our information. Likewise, some companies may have been promoted by some FIs jointly with banks; in these cases also, a suitable arrangement for ensuring broad supervision may be devised by consent amongst all the equity holders, under advice to us.

4. CLASSIFICATION OF INVESTMENTS

4.1 The entire investment portfolio of the FIs will be classified under three categories viz. **'Held to Maturity', 'Available for Sale'** and **'Held for Trading'**. The securities acquired by the FIs with the intention to hold them till maturity will be classified under Held to Maturity. The securities acquired by the FIs with the intention to trade by taking advantage of the short-term price/ interest rate movements etc. 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.

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

4.3 Held to Maturity

4.3.1 In keeping with the international norms, only debt securities are to be classified under the HTM category. The only **exceptions permitted (**as detailed at para 4.3.4 below) are the equity held in the subsidiaries and joint ventures, investments in

preference shares in the nature of advance, non project related redeemable shares and the investments in units of close ended schemes of mutual funds only if such units are listed on the stock exchanges (as listed units of close ended schemes can be sold off in the market at any point of time; which should therefore be placed in AFS or HFT category).

4.3.2 The investments included under "Held to Maturity" should not exceed 25 per cent of the total investments. The FIs may include, at their discretion, under Held to Maturity category securities less than 25 per cent of total investment.

4.3.3 Financial Institution's aggregate investment in Tier II bonds issued by other FIs/ banks shall be permitted up to 10 per cent of the total capital of the investing Financial Institution. The total capital for this purpose will be the same as that reckoned for the purpose of capital adequacy.

4.3.3 <u>Computation of the 25% ceiling:</u>

For computing the ceiling of 25% for the HTM category, the following type of investments should be **excluded** from the total investments and 25% of the balance amount would constitute the ceiling:

a) Equity held in subsidiaries / Joint Ventures;
b) Bonds / debentures and preference shares meeting the prescribed criteria and treated in the nature of advance;
c) Other investments (equity shares) in the nature of advance which may be held in the AFS category.

4.3.4 <u>Exclusions from the 25% ceiling</u>

The following investments will be included under "Held to Maturity" but will **not** be counted for the purpose of ceiling of 25% for the category:

a) Investment in subsidiaries and joint ventures:

A Joint Venture would be an entity in which a FI (along with the holdings, if any, by its subsidiary) holds more than 25% of equity capital **pursuant to a Joint Venture agreement** duly entered into between / amongst the FI and the joint venture partner(s) for furtherance of a commercial objective. Besides, the companies floated by the FIs and in which the FI (along with the holdings, if any, by its subsidiaries) holds more than 25 per cent of the equity share capital, would also be classified as a Joint Venture. 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

Only such equity holdings, as also the equity held in subsidiaries, should be placed in the HTM category – and not where a FI, along with its subsidiaries, acquires equity in excess of 25% on account of conversion of loan, venture capital assistance, etc.

b) The investments in debentures/ bonds, which are deemed to be in the nature of an advance:

The bonds and debentures should be treated in the nature of advance when:

- The debenture / bond is issued as part of the proposal for project finance and the tenor of the bond / debenture is for three years and above.

and

- The FI has a significant stake (i.e. 10% or more) in the issue

and

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

c) Preference Shares:

The preference shares, other than convertible preference shares, on account of their definite maturity period, may be included in the HTM category, regardless of their period of maturity, subject to the following:

- ♦ 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 in the nature of advance. Such preference shares would also not be counted for the purpose of the ceiling of 25% on the investments in the HTM category.

- ♦ 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. Such preference shares would also not be counted for the purpose of the ceiling of 25% on the investments in the HTM category.

All other preference shares, if kept in the HTM category, should be reckoned within the ceiling of 25% for the investments in the HTM category. Such shares should be valued at the acquisition cost unless acquired at a premium, in which case they should be valued at the amortised cost. Any diminution, other than temporary, in

value of these shares should be determined and provided for each investment individually and should not be set off against appreciation in other preference shares.

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.

4.4 Available for Sale & Held for Trading

4.4.1 The FIs 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.

4.4.2 The investments classified under Held for Trading category would be those from which the FI 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 FI 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.

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

4.5 Shifting among categories:

4.5.1 FIs 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.

4.5.2 FIs 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 FI/ Head of the ALCO, but should be ratified by the Board of Directors/ ALCO.

4.5.3 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 above subject to depreciation, if any, applicable on the date of transfer, with the approval of the Board of Directors/ ALCO / Investment Committee.

4.5.4 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.

5. VALUATION OF INVESTMENTS

5.1 Held to Maturity

5.1.1 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.

5.1.2 FIs 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.

5.2 Available for Sale

5.2.1 The individual scrips in the Available for Sale category will be marked to market at the year-end or at more frequent intervals. The net depreciation under each classification mentioned below should be recognised and fully provided for, the net appreciation under these classifications should be ignored. The book value of the individual securities would not undergo any change after the revaluation.

5.2.2 The classifications of investment will be (i) Government securities (ii) Other approved securities (iii) Shares (iv) Debentures & Bonds (v) Subsidiaries / joint ventures (vi) Others (CP, Mutual Fund Units, etc.).

5.2.3 Securities under this category shall be valued scrip-wise and depreciation/ appreciation shall be aggregated for each classification as 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.

5.2.4 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) 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) 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.

5.3 Held for Trading

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 of the six classifications referred to above will be recognised in the income account. The book value of the individual scrip will change with the revaluation.

5.4 General

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

5.5 Market value

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, price of SGL Account transactions, price list of RBI, prices declared by Primary Dealers

Association of India (PDAI) Jointly with the Fixed Income Money Market and Derivative Association of India (FIMMDA) periodically. In respect of **unquoted securities**, the procedure as detailed below should be adopted.

5.6 Valuation of unquoted securities

5.6.1 Central Government securities

The FIs should value the unquoted Central Government Securities on the basis of the prices/YTM rates put out by the PDAI / FIMMDA at periodical intervals.

Treasury Bills should be valued at carrying cost.

5.6.2 State Government Securities

Unquoted 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.

5.6.3 Other 'approved' Securities

The 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.

5.6.4 Debentures/ Bonds

All debentures/bonds other than debentures/bonds which are in the nature of advance should be valued on the YTM basis. Such debentures 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.

5.6.5 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 equal 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 FI.

(c) Where interest/ principal on the debenture/bond is in arrears, the provision should be made for the debentures/bonds 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/bond 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.

5.6.6 Preference Shares

A. Preference shares not in the nature of advance

A.I Tax-free preference shares

In the context of certain queries received, when the dividend on the preference shares was tax-free under the Income Tax Act, the following guidelines for valuation of such preference shares had been prescribed in October 2001.

The guidelines framed by FIMMDA for valuation of tax-free bonds should be followed for valuation of unquoted tax-free preference shares, other than those kept in the HTM category, as per the following procedure:

a) Gross up the nominal (tax-free) dividend rate on the preference shares by the marginal income tax rate of the FI – which might change from year-to-year – to get the cum-tax dividend rate ;

b) Find the YTM of the GoI security of the equal residual maturity from the rates declared by FIMMDA;

c) Add the applicable credit spread / risk premium (as per the rating of the preference shares) specified by FIMMDA for that risk category, to the YTM of the GoI security arrived at step (b) above.

d) In case of **unrated preference shares**, the credit spread / risk premium to be added to the YTM of the GoI security arrived at (b) above, should be determined in the following manner:

(i) In case the company issuing unrated preference shares has any other rated instruments which are outstanding, then a rating one full-notch below that rating should be arrived at. (For instance, for a 'AAA' rating, only 'AA' rating should be reckoned.). In case more than one rated instrument issued by the company is outstanding, then the rating of that instrument which has been assigned the rating most recently, should be reckoned. The risk spread corresponding to such rating, as announced by FIMMDA, would be the spread to be added to the YTM of the GoI security.

(ii) In case, no other instrument of the company issuing the preference shares has been rated and is outstanding, then a credit spread not less

than the spread applicable to a bond of minimum investment grade, i.e., a 'BBB' rated bond, would be the spread to be added to the YTM of the GoI security.

e) Compare the grossed up/ cum-tax dividend rate of step (a) above with the risk-adjusted YTM of the preference share arrived at step (c) or (d) above and use the **higher** of the two rates as the effective YTM for valuation of the preference share.

f) 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 equal maturity.

g) Where preference dividends are in arrears, no credit should be taken for accrued dividends (the period of pendency should be reckoned as per the extant prudential norms) 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 against other preference shares.

h) 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.

A.II <u>Preference shares with taxable dividend</u>

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 following valuation methodology for the unquoted preference shares should be adopted:

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 by the rating agencies subject to the following:

(i) 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 FI. In case the company issuing unrated preference shares has any other rated instruments which are outstanding, then a rating one full-notch below that rating should be arrived at. (For instance, for a 'AAA' rating, only 'AA' rating should be reckoned). In case more than one rated instrument issued by the company is outstanding, then the rating of that instrument which has been assigned the rating most recently, should be reckoned. The risk spread corresponding to such rating, as announced by FIMMDA, would be the spread to be added to the YTM of the GoI security. In

case, no other instrument of the company issuing the preference shares has been rated and is outstanding, then a credit spread not less than the spread applicable to a bond of minimum investment grade, i.e., a ‘BBB’ rated bond, would be the spread to be added to the YTM of the GoI security.

(ii) 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 equal maturity.

c) Value the preference share as per the following formula:

$$\frac{\text{(YTM of the preference share)}}{\text{rate arrived at step (b) above}} \times 100$$

subject to following conditions

(i) Where preference dividends are in arrears, no credit should be taken for accrued dividends (the period of pendency should be reckoned as per the extant prudential norms) 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 against other preference shares.

(ii) 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.

B. Preference shares in the nature of advance

Preference shares in the nature of advance, as defined earlier **(Cf. Para4.3.4 (c) above)** should be valued by notionally extending to them the asset-classification of the outstanding loans of the issuing company and provision for depreciation in the value of preference shares made accordingly. In case the said loans are in the standard category, provision as per norms applicable to the standard loan assets would be required for the depreciation in the value of these shares. In case the loans are in the doubtful category, the preference shares held should be treated as an unsecured facility and fully provided for.

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.

C. Non project related and redeemable Preference shares

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.**

5.6.7 Equity Shares

A. Equity Shares in the nature of advance

The equity holdings in the nature of advance should be **compulsorily placed in the 'Available For Sale' category**. 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. Such equity should be valued by notionally extending to it the asset-classification of the outstanding loans of the issuing company and provision for depreciation in the value of equity made accordingly. In case the said loans are in the standard category, provision as applicable to the standard loan assets would be required for the depreciation in the equity value but in case the loans are in the doubtful category, the equity held should be treated as an unsecured facility and fully provided for.

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.

B. Equity Shares not in the nature of advance

In respect of other investments in equity shares valuation may be done as per the market value which would be the market price of the scrip as available from the trades / quotes on the stock exchange. Those scrips for which current quotations are not available or where the shares are not quoted on Stock Exchange, 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. In case the latest balance sheet is not available the shares are to be valued at rupee one per company.

<u>Definitions</u>:

a) Quoted equity share:

An equity share, if the latest market quotation available, as at the date of valuation, is **more than 30 day-old,** it may be considered to be an **unquoted investment** and valued at break up value, as prescribed. Furthermore, the market price for valuation of quoted equity shares should not be derived from a solitary trade for a small-volume transaction but should be the price observed for a reasonable volume of transaction between two independent parties in an arms-length relationship.

b) **Thinly-traded shares /** equity related securities' (such as convertible debentures, equity warrants, etc.) should be identified and valued as detailed below.

> Thinly traded equity shares / equity related securities would be those for which the trading in a month is for less than Rs. 5 lakh or the total trading volume is less than 50,000 shares.
>
> Where the stock exchange concerned identifies such securities as per the foregoing criteria and publishes / provides such information for the preceding

calendar month along with the daily quotations, such latest quotations should be used for valuation of such shares.

In case the equity is listed on a stock exchange, which does not provide such information, the FIs may undertake their own analysis as per above criteria to determine whether the share is a thinly traded one. If so, the latest available quotation should be used for valuation

The age of the "latest" balance sheet:

In respect of companies, which close their annual accounts on dates other than 31 March, the latest balance sheet used for determining the break up value **should not be older than 21 months**, as on the date of valuation.

(The period of 21 months was introduced as against 12 months in view of certain operational problems pointed out by FIs in case of companies which close their annual accounts on dates other than 31st March.)

5.6.8 Mutual Funds Units

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.

5.6.9 Commercial Paper

Commercial paper should be valued at the carrying cost.

6. CONVERSION OF DEBT INTO EQUITY AND OTHER INSTRUMENTS IN CASE OF RESTRUCTURED ACCOUNTS

The amount outstanding converted into other instruments would normally comprise principal and the interest components. If the amount of interest dues is converted into equity or any other instrument, and income is recognised in consequence, full provision should be made for the amount of income so recognised to offset the effect of such income recognition. Such provision would be in addition to the amount of provision that may be necessary for the depreciation in the value of the equity or other instruments, as per the investment valuation norms.

However, if the conversion of interest is into equity, which is quoted, interest income can be recognised at market value of equity, as on the date of conversion, not exceeding the amount of interest converted to equity. Such equity must thereafter be classified in the "available for sale" category and valued at lower of cost or market value.

In case of conversion of principal and /or interest in respect of NPAs into debentures, such debentures should be treated as NPA, *ab initio*, in the same asset classification as was applicable to loan just before conversion and provision made as per norms. This norm would also apply to zero coupon bonds or other instruments, which seek to defer the liability of the issuer. On such debentures, income should be recognised only on realisation basis. The income in respect of unrealised interest, which is converted into debentures, or any other fixed maturity instrument should be recognised only on redemption of such instrument. Subject to the above, the equity shares or other instruments arising from conversion of the principal amount of loan would also be subject to the usual prudential valuation norms as applicable to such instruments.

7. HEDGING OF INVESTMENTS WITH EXCHANGE TRADED INTEREST RATE DERIVATIVES

7.1 In June 2003 it was decided to introduce exchange traded Interest Rate Derivatives (IRDs) to enable better risk management in the Indian market. In the first phase, the Securities and Exchange Board of India (SEBI) has decided to introduce anonymous order driven system for trading in Interest Rate Derivatives (IRDs) on The Stock Exchange, Mumbai (BSE) and National Stock Exchange (NSE) .

7.2 With a view to enabling regulated entities to manage their exposure to interest rate risks, it has been decided to allow Scheduled Commercial Banks (SCBs) excluding RRBs & LABs, Primary Dealers (PDs) and specified All India Financial Institutions (AIFIs) to deal in IRDs in a phased manner. In the first phase, such entities can transact only in interest rate futures on notional bonds and T-Bills for the limited purpose of hedging the risk in their underlying investment portfolio. Allowing transactions in a wider range of products, as also market making will be considered in the next stage on the basis of the experience gained.

7.3 While derivatives present immense opportunity for mitigating the market risks inherent in the balance sheet, it can also expose one to substantial losses on account of inadequate understanding of the product, absence of proper monitoring, poor risk control measures, etc. SCBs and AIFIs desirous of transacting in IRDs on the stock exchanges should take specific approval from their respective Boards covering, *inter alia*, the products that they may transact in, size/composition of the investment portfolio intended to be hedged, organizational set-up to monitor, rebalance, report, account and audit such transactions. Further, it is desirable that derivative desks are created within the treasury and the management level responsibility clearly assigned.

7.4 The following norms will be applicable for transacting IRDs on the Futures and Options (F & O) segment of the stock exchanges:

i) *Stock exchange regulations*: SCBs and AIFIs can seek membership of the F & O segment of the stock exchanges for the limited purpose of undertaking proprietary transactions for hedging interest rate risk. SCBs and AIFIs desirous of taking trading membership on the F & O segment of the stock exchanges should satisfy the membership criteria and also comply with the regulatory norms laid down by SEBI and the respective stock exchanges (BSE/NSE). Those not seeking membership of Stock Exchanges, can transact IRDs through approved F & O members of the exchanges.

ii) *Settlement*:

a) As trading members of the F&O segment, SCBs and AIFIs should settle their derivative trades directly with the clearing corporation/clearing house.

b) Regulated entities participating through approved F & O members shall settle proprietary trades as a participant clearing member or through approved professional / custodial clearing members.

c) Broker / trading members of stock exchanges cannot be used for settlement of IRD transactions.

iii) *Eligible underlying securities*: For the present, only the interest rate risk inherent in the government securities classified under the **Available for Sale** and **Held for Trading** categories will be allowed to be hedged. For this purpose, the portion of the Available for Sale and Held for Trading portfolio intended to be hedged must be identified and carved out for monitoring purposes.

iv) *Hedge criteria:* Interest Rate Derivative transactions undertaken on the exchanges shall be deemed as hedge transactions, if and only if,

a) The hedge is clearly identified with the underlying government securities in the Available for Sale and Held for Trading categories.

b) The effectiveness of the hedge can be reliably measured

c) The hedge is assessed on an ongoing basis and is “highly effective” throughout the period.

v) *Hedge Effectiveness* : The hedge will be deemed to be “highly effective” if at inception and throughout the life of the hedge, changes in the marked to market value of the hedged items with reference to the marked to market value at the time of the hedging are “almost fully offset” by the changes in the marked to market value of the hedging instrument and the actual results are within a range of 80% to 125%. If changes in the marked to market values are outside the 80% -125% range, then the hedge would not be deemed to be highly effective.

At present, the investments held in the (a) AFS category are to be marked to market at quarterly or more frequent intervals (b) HFT category are to be marked to market at monthly or more frequent intervals. The hedged portion of the AFS/ HFT portfolio should be notionally marked to market, at least at monthly intervals, for evaluating the efficacy of the hedge transaction.

vi) *Accounting*: The Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI) is in the process of developing a comprehensive Accounting Standard covering various types of financial instruments including accounting for trading and hedging. However, as the formulation of the Standard is likely to take some time, the Institute has brought out a Guidance Note on Accounting for Equity Index Futures as an interim measure. Till ICAI comes out with a comprehensive Accounting Standard, SCBs and AIFIs may follow the above guidance note *mutatis mutandis* for accounting of interest rate futures also. However, since SCBs and AIFIs are being permitted to hedge their underlying portfolio which is subject to periodical mark to market, the following norms will apply

a) If the hedge is “highly effective”, the gain or loss on the hedging instruments and hedged portfolio may be set off and net loss, if any, should be provided for and net gains if any, ignored for the purpose of Profit & Loss Account.
b) If the hedge is not found to be "highly effective" no set off will be allowed and the underlying securities will be marked to market as per the norms applicable to their respective investment category.

c) Trading position in futures is not allowed. However, a hedge may be temporarily rendered as not “highly effective”. Under such circumstances, the relevant futures position will be deemed as a trading position. All deemed trading positions should be marked to market as a portfolio on a daily basis and losses should be provided for and gains, if any, should be ignored for the purpose of Profit & Loss Account. SCBs and AIFIs should strive to restore their hedge effectiveness at the earliest.

d) Any gains realized from closing out / settlement of futures contracts can not be taken to Profit & Loss account but carried forward as "Other Liability" and utilized for meeting depreciation provisions on the investment portfolio.

vii) *Capital adequacy*: The net notional principal amount in respect of futures position with same underlying and settlement dates should be multiplied by the conversion factor given below to arrive at the credit equivalent:

Original Maturity	**Conversion Factor**
Less than one year	0.5 per cent
One year and less than two years	1.0 per cent
For each additional year	1.0 per cent

The credit equivalent thus obtained shall be multiplied by the applicable risk weight of 100%.

viii) *ALM classification:* Interest rate futures are treated as a combination of a long and short position in a notional government security. The maturity of a future will be the period until delivery or exercise of the contract, as also the life of the underlying instrument. For example, a short position in interest rate future for Rs. 50 crore [delivery date after 6 months, life of the notional underlying government security 3½ years] is to be reported as a risk sensitive asset under the 3 to 6 month bucket and a risk sensitive liability in four years i.e. under the 3 to 5 year bucket.

ix) *Use of brokers*: The existing norm of 5% of total transactions during a year as the aggregate upper contract limit for each of the approved brokers should be observed by SCBs and AIFIs who participate through approved F & O members of the exchanges.

x) *Disclosures:* The regulated entities undertaking interest rate derivatives on exchanges may disclose as a part of the notes on accounts to balance sheets the following details:

(Rs. Crores)

Sr.No	Particulars	Amount
1	Notional principal amount of exchange traded interest rate derivatives undertaken during the year (instrument-wise) a) b) c)	
2	Notional principal amount of exchange traded interest rate derivatives outstanding as on 31st March _____ (instrument-wise) a) b) c)	
3	Notional principal amount of exchange traded interest rate derivatives outstanding and not “highly effective” (instrument-wise) a) b) c)	

4	Mark-to-market value of exchange traded interest rate derivatives outstanding and not "highly effective" (instrument-wise) a) b) c)	

xi) *Reporting:* Banks and Specified AIFIs should submit a monthly statement to DBS or DBS (FID) respectively as per the following format .

MONTHLY RETURN ON EXCHANGE TRADED INTEREST RATE FUTURES

Name of the Bank/ specified AIFI: …………………………………..

As on last working day of the month: …………………………………..

I. Analysis of outstanding futures position:

Settlement dates of the Futures Contract outstanding in the books	Underlying interest rate exposure of the futures contract	Number of Contracts outstanding in the books	Open Interest position of the futures contract

II. Activity during the month :

NPA* of the futures contract outstanding at the beginning of the month (settlement date / underlying interest rate exposure wise break up)	NPA* entered into during the month (settlement date / underlying interest rate exposure wise break up)	NPA* of the futures contract reversed during the month (settlement date / underlying interest rate exposure wise break up)	NPA* outstanding at the end of the month (settlement date / underlying interest rate exposure wise break up)

III. Analysis of "highly effective" hedges:

Size of the underlying investment portfolio being hedged	Change in MTM*** value of the underlying hedge portfolio since inception of hedge	Change in MTM*** value of the futures position since inception of hedge	PV01** of the underlying investment portfolio being hedged	PV01** of the hedging futures position

IV. Analysis of not "highly effective" hedges:

Size of the underlying investment portfolio intended to be hedged	Change in MTM*** value of the underlying hedge portfolio since inception of hedge	Change in MTM*** value of the futures position since inception of hedge	Duration for which the hedge was ineffective	Remark : Action if any, to restore hedge effectiveness

* NPA - Notional principal amount; **PV01-Price value of a basis point
***MTM- Marked to market

8. REPO ACCOUNTING

Market participants may undertake repos from any of the three categories of investments, viz., **Held For Trading**, **Available For Sale** and **Held To Maturity**.

The legal character of repo under the current law, viz. as outright purchase and outright sale transactions will be kept intact by ensuring that the securities sold under repo (the entity selling referred to as "seller") are excluded from the Investment Account of the seller of securities and the securities bought under reverse repo (the entity buying referred to as "buyer") are included in the Investment Account of the buyer of securities. Further, the buyer can reckon the approved securities acquired under reverse repo transaction for the purpose of Statutory Liquidity Ratio (SLR) during the period of the repo.

At present repo transactions are permitted in Central Government securities including Treasury Bills and dated State Government securities. Since the buyer of the securities will not hold it till maturity, the securities purchased under reverse repo by FIs should not be classified under **Held to Maturity** category. The first leg of the repo should be contracted at the prevailing market rates. Further, the accrued interest received / paid in a repo / reverse repo transaction and the clean price (i.e. total cash consideration less accrued interest) should be accounted for separately and distinctly.

The other accounting principles to be followed while accounting for repos / reverse repos will be as under:

8.1 Coupon

In case the interest payment date of the security offered under repo falls within the repo period, the coupons received by the buyer of the security should be passed on to the seller on the date of receipt as the cash consideration payable by the seller in the second leg does not include any intervening cash flows. While the buyer will book the coupon during the period of the repo , the seller will not accrue the coupon during the period of the repo. In the case of discounted instruments like Treasury Bills, since there is no coupon, the seller will continue to accrue the discount at the original discount rate during the period of the repo. The buyer will not therefore accrue the discount during the period of the repo.

8.2 Repo Interest Income / Expenditure

After the second leg of the repo / reverse repo transaction is over:

(a) the difference in the clean price of the security between the first leg and the second leg should be reckoned as Repo Interest Income / Expenditure in the books of the buyer / seller respectively ;

(b) the difference between the accrued interest paid between the two legs of the transaction should be shown as Repo Interest Income/ Expenditure account, as the case may be; and

(c) the balance outstanding in the Repo interest Income / Expenditure account should be transferred to the Profit and Loss account as an income or an expenditure .

As regards repo / reverse repo transactions *outstanding on the balance sheet date* , only the accrued income / expenditure *till the balance sheet date* should be taken to the Profit and Loss account. Any repo income / expenditure for the subsequent period in respect of the outstanding transactions should be reckoned for the next accounting period.

8.3 Marking to Market

The buyer will mark to market the securities acquired under reverse repo transactions as per the *investment classification of the security*. To illustrate, for banks , in case the securities acquired under reverse repo transactions have been classified under **Available for Sale** category, then the mark to market valuation for such securities should be done at least once a quarter. For entities, which do not follow any investment classification norms, the *valuation for securities acquired under reverse repo transactions may be in accordance with the valuation norms followed by them in respect of securities of similar nature.*

In respect of the repo transactions outstanding as on the balance sheet date

(a) The buyer will mark to market the securities on the balance sheet date and will account for the same as laid down in the extant valuation guidelines issued by the respective regulatory departments of RBI.

(b) The seller will provide for the price difference in the Profit & Loss account and show this difference under "Other Assets" in the balance sheet if the sale price of the security offered under repo is lower than the book value.

(c) The seller will ignore the price difference for the purpose of Profit & Loss account but show the difference under "Other Liabilities" in the balance sheet if the sale price of the security offered under repo is higher than the book value; and

(d) Similarly the accrued interest paid / received in the repo / reverse repo transactions outstanding on balance sheet dates should be shown as "Other Assets" or "Other Liabilities" in the balance sheet.

8.4 Book value on re-purchase

The seller shall debit the repo account with the original book value (as existing in the books on the date of the first leg) on buying back the securities in the second leg.

8.5 Disclosure

The following disclosures should be made by the FIs in the "Notes on Accounts' to the Balance Sheet:

(Rs. In crore)

	Minimum outstand-ing during the year	Maximum outstand-ing during the year	Daily Average outstanding during the year	Outstand -ing as on March 31
Securities sold under repos				
Securities purchased under reverse repos				

8.6 Accounting methodology

The accounting methodology to be followed, along with illustrations, is given in the **Annexes III and IV**. While market participants, having different accounting systems, may use accounting heads different from those used in the illustration, there should not be any deviation from the accounting principles enunciated above. Further, to obviate disputes arising out of repo transactions , the participants may consider entering into bilateral Master Repo Agreement as per the documentation finalized by FIMMDA .

ANNEX-I
(Cf. Para 2.3.9)

Scheme for Non-competitive Bidding Facility in the Auctions of Government Securities

I. Scope : With a view to encouraging wider participation and retail holding of Government securities it is proposed to allow participation on "*non-competitive*" basis in *select* auctions of dated Government of India securities. Accordingly, non-competitive bids *up to 5 percent* of the notified amount will be accepted in the auctions of dated securities. The reserved amount will be **within** the notified amount.

II. Eligibility: Participation on a non-competitive basis in the auctions of dated GOI securities will be open to investors who satisfy the following:

1. do not maintain current account (CA) *or* Subsidiary General Ledger (SGL) account with the Reserve Bank of India.

   Exceptions: Regional Rural Banks (RRBs), Urban Cooperative Banks (UCBs) and Non-banking Financial Companies (NBFCs) shall be covered under this Scheme in view of their statutory obligations.

2. make a *single* bid for an amount not more than rupees one crore (face value) per auction

3. submit their bid *indirectly* through any *one* bank or PD offering this scheme.

   Exceptions: Regional Rural Banks (RRBs), Urban Cooperative Banks (UCBs) and Non-banking Financial Companies (NBFCs) shall be eligible to submit their non-competitive bids directly.

III. Coverage: Subject to the conditions mentioned above, participation on "non-competitive" basis is open to any person including firms, companies, corporate bodies, institutions, provident funds, trusts, and any other entity as may be prescribed by RBI. The minimum amount for bidding will be Rs.10,000 (face value) and thereafter in multiples in Rs.10,000 as hitherto for dated stocks.

IV. <u>Other Operational Guidelines:</u>

1. It will *not* be mandatory for the retail investor to maintain a constituent subsidiary general ledger (CSGL) account with the bank or PD through whom they wish to participate. However, an investor can make only a single bid under this scheme. An undertaking to the effect that the investor is making only a single bid will have to be obtained and kept on record by the bank or PD.

2. Each bank or PD on the basis of *firm* orders submit a single *customer bid* for the aggregate amount on the day of the auction. Details of individual customers viz. name, amount, etc shall be provided as an Annexure to the bid.

3. Allotment under the non-competitive segment to the bank or PD will be at the weighted average rate of yield/price that will emerge in the auction on the basis of the competitive bidding. The securities will be issued to the bank or PD against payment on the date of issue irrespective of whether the bank or PD has received payment from their clients.

4. In case the aggregate amount of bid is more than the reserved amount (5% of notified amount), pro rata allotment would be made. In case of partial allotments, it will be the responsibility of the bank or PD to appropriately allocate securities to their clients in a transparent manner.

5. In case the aggregate amount of bids is less than the reserved amount, the shortfall will be taken to competitive portion.

6. Security would be issued *only* in SGL form by RBI. RBI would credit either the main SGL account or the CSGL account of the bank or PD as indicated by them. The facility for affording credit to the main SGL account is for the sole purpose of servicing investors who are not their constituents. Therefore, the bank or PD would have to indicate clearly at the time of tendering the non-competitive bids the amounts (*face value*) to be credited to their SGL account and the CSGL account. Delivery in physical form from the main SGL account is permissible at the instance of the investor subsequently.

7. It will be the responsibility of the bank or the PD to pass on the securities to their clients. Except in extraordinary circumstances, the transfer of securities to the clients shall be completed within *five* working days from the date of issue.

8. The bank or PD can recover upto six paise per Rs.100 as brokerage/commission/ service charges for rendering this service to their clients. Such costs may be built into the sale price or recovered separately from the clients. In case the transfer of securities is effected subsequent to the issue date of the security, the consideration amount payable by the client to the bank or PD would also include accrued interest from the date of issue.

9. Modalities for obtaining payment from clients towards cost of the securities, accrued interest wherever applicable and brokerage/commission/service charges may be worked out by the bank or PD as per agreement with the client. It may be noted that no other costs such as funding costs should be built into the price or recovered from the client.

V. Banks and PDs will be required to furnish information relating to operations under the Scheme to the Reserve Bank of India (Bank) as may be called for from time to time within the time frame prescribed by the Bank.

VI. The aforesaid guidelines are subject to review by the Bank and accordingly, if and when considered necessary, the Scheme will be modified.

ANNEX II

(CF PARA 2.5.9)

FORMAT FOR DISCLOSURE IN THE "NOTES ON ACCOUNTS" IN THE

ANNUAL PUBLISHED REPORTS

A. Issuer categories in respect of investments made

(As on the date of the balance sheet)

Sr. No.	Issuer	Amount	Amount of			
			Investment made through Pvt. Placement	"Below Investment" grade Securities Held	Unrated Securities Held	Unlisted Securities
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1	PSUs					
2	FIs					
3	Banks					
4	Private Corporates					
5	Subsidiaries/ Joint Ventures					
6	Others					
7	# Provision held towards depreciation					
	Total*					

Only aggregate amount of provision held to be disclosed in column 3.

* **NOTES:**

1. Total under column 3 should tally with the total of investments included under the following categories in the balance sheet:

a. Shares
b. Debentures & Bonds
c. Subsidiaries/ joint ventures
d. Others

2. Amounts reported under columns 4, 5, 6 and 7 above might **not** be mutually exclusive.

B. Non performing investments

Particulars	Amount (Rs. Crore)
Opening balance	
Additions during the year since 1st April	
Reductions during the above period	
Closing balance	
Total provisions held	

ANNEX-III
(Cf. Para 8.6)

Recommended Accounting Methodology for Uniform Accounting of Repo / Reverse Repo transactions

a. The following accounts may be opened , viz. i) Repo Account, ii) Repo Price Adjustment Account, iii) Repo Interest Adjustment Account, iv) Repo Interest Expenditure Account, v) Repo Interest Income Account, vi) Reverse Repo Account, vii) Reverse Repo Price Adjustment Account, and viii) Reverse Repo Interest Adjustment Account.

b. The securities sold/ purchased under repo should be accounted for as an outright sale / purchase.

c. The securities should enter and exit the books at the same book value. For operational ease, the weighted average cost method, whereby the investment is carried in the books at their weighted average cost, may be adopted.

Repo

d. In a repo transaction, the securities should be sold in the first leg at market related prices and re-purchased in the second leg at the derived price. The sale and repurchase should be accounted in the Repo Account.

e. The balances in the Repo Account should be netted from the FI's Investment Account for balance sheet purposes.

f. The difference between the market price and the book value in the first leg of the repo should be booked in Repo Price Adjustment Account. Similarly the difference between the derived price and the book value in the second leg of the repo should be booked in the Repo Price Adjustment Account.

Reverse repo

g. In a reverse repo transaction, the securities should be purchased in the first leg at prevailing market prices and sold in the second leg at the derived price. The purchase and sale should be accounted for in the Reverse Repo Account.

h. The balances in the Reverse Repo Account should be part of the Investment Account for balance sheet purposes and can be reckoned for SLR purposes (only for banks) if the securities acquired under reverse repo transactions are approved securities.

i. The security purchased in a reverse repo will enter the books at the market price (excluding broken period interest). The difference between the derived price and the book value in the second leg of the reverse repo should be booked in the Reverse Repo Price Adjustment Account.

Other aspects relating to Repo / Reverse Repo

j. In case the interest payment date of the security offered under repo falls within the repo period, the coupons received by the buyer of the security should be passed on to the seller on the date of receipt as the cash consideration payable by the seller in the second leg does not include any intervening cash flows.

k. The difference between the amounts booked in the first and second legs in the Repo / Reverse Repo Price Adjustment Account should be transferred to the Repo Interest Expenditure Account or Repo Interest Income Account, as the case may be.

l. The broken period interest accrued in the first and second legs will be booked in Repo Interest Adjustment Account or Reverse Repo Interest Adjustment Account, as the case may be. Consequently the difference between the amounts booked in this account in the first and second legs should be transferred to the Repo Interest Expenditure Account or Repo Interest Income Account, as the case may be.

m. At the end of the accounting period, for *outstanding repos* , the balances in the Repo / Reverse Repo Price Adjustment Account and Repo / Reverse repo Interest Adjustment Account should be reflected either under item VI - 'Others' under Schedule 11 - 'Other Assets' *or* under item IV 'Others (including Provisions)' under Schedule 5 - 'Other Liabilities and Provisions' in the Balance Sheet of banks, as the case may be. (The FIs may reflect the balances in the corresponding Heads of accounts in their balance sheet).

n. Since the debit balances in the Repo Price Adjustment Account at the end of the accounting period represent losses not provided for in respect of securities offered in outstanding repo transactions, it will be necessary to make a provision therefor in the Profit & Loss Account.

o. To reflect the accrual of interest in respect of the outstanding repo/ reverse repo transactions at the end of the accounting period, appropriate entries should be passed in the Profit and Loss account to reflect Repo Interest Income / Expenditure in the books of the buyer / seller, respectively, and the same should be debited / credited as an income / expenditure accrued but not due. Such entries passed should be reversed on the first working day of the next accounting period.

p. In respect of repos in interest bearing (coupon) instruments, the buyer would accrue interest during the period of repo. In respect of repos in discount instruments like Treasury Bills, the seller would accrue discount during the period of repo based on the original yield at the time of acquisition.

q. At the end of the accounting period the debit balances (excluding balances for repos which are still outstanding) in the Repo Interest Adjustment Account and Reverse Repo Interest Adjustment Account should be transferred to the Repo Interest Expenditure Account and the credit balances (excluding balances for repos which are still outstanding) in the Repo Interest Adjustment Account and Reverse Repo Interest Adjustment Account should be transferred to the Repo Interest Income Account.

r. Similarly, at the end of accounting period, the debit balances (excluding balances for repos which are still outstanding) in the Repo / Reverse Repo Price Adjustment Account should be transferred to the Repo Interest Expenditure Account and the credit balances (excluding balances for repos which are still outstanding) in the Repo / Reverse Repo Price Adjustment Account should be transferred to the Repo Interest Income Account.

s. Illustrative examples are given in **Annex IV.**

Annex-IV
(Cf. Para 8.6)

Illustrative examples for uniform accounting of Repo/Reverse repo transactions

A. Repo/ Reverse Repo of Coupon bearing security

1. Details of Repo in a coupon bearing security:

Security offered under Repo	11.43% 2015	
Coupon payment dates	7 August and 7 February	
Market Price of the security offered under Repo (i.e. price of the security in the first leg)	Rs.113.00	**(1)**
Date of the Repo	19 January, 2003	
Repo interest rate	7.75%	
Tenor of the repo	3 days	
Broken period interest for the first leg*	11.43%x162/360x100=5.1435	**(2)**
Cash consideration for the first leg	(1) + (2) = 118.1435	**(3)**
Repo interest**	118.1435x3/365x7.75%=0.0753	**(4)**
Broken period interest for the second leg	11.43% x 165/360x100=5.2388	**(5)**
Price for the second leg	(3)+(4)-(5) = 118.1435 + 0.0753 - 5.2388 = 112.98	**(6)**
Cash consideration for the second leg	(5)+(6) = 112.98 + 5.2388 = 118.2188	**(7)**

* Computation of days based on 30/360 day count convention
** Computation of days based on Actual/365 day count convention applicable to money market instruments

2. Accounting for the seller of the security

We assume that the security was held by the seller at the book value (BV) of Rs.120.0000

First leg Accounting

	Debit	Credit
Cash Repo Account	118.1435	120.0000 (Book value)
Repo Price Adjustment account	7.0000 (Difference between BV & repo price)	
Repo Interest Adjustment account		5.1435

Second Leg Accounting

	Debit	Credit
Repo Account Repo Price Adjustment account	120.0000	7.02 (the difference between the BV and 2nd leg price)
Repo Interest Adjustment account Cash account	5.2388	118.2188

The balances in respect of the Repo Price Adjustment Account and Repo Interest Adjustment Account at the end of the second leg of repo transaction are transferred to Repo Interest Expenditure Account. In order to analyse the balances in these accounts, the ledger entries are shown below:

Repo Price Adjustment account

Debit		Credit	
Difference in price for the 1st leg	7.00	Difference in price for the 2nd leg	7.02
Balance carried forward to Repo Interest Expenditure account	0.02		
Total	7.02	Total	7.02

Repo Interest Adjustment account

Debit		Credit	
Broken period interest for the 2nd leg	5.2388	Broken period interest for the 1st leg	5.1435
		Balance carried forward to Repo Interest Expenditure account	0.0953
Total	5.2388	Total	5.2388

Repo Interest Expenditure Account

Debit		Credit	
Balance from Repo Interest Adjustment account	0.0953	Balance from Repo Price Adjustment account	0.0200
		Balance carried forward to P & L a/c.	0.0753
Total	0.0953	Total	0.0953

3. Accounting for buyer of the security

When the security is bought, it will bring its book value with it. Hence market value is the book value of the security.

First leg Accounting:

	Debit	Credit
Reverse Repo Account	113.0000	
Reverse Repo Interest Adjustment account	5.1435	
Cash account		118.1435

Second Leg Accounting

	Debit	Credit
Cash account	118.2188	
Reverse Repo Price Adjustment account (Difference between the 1st and 2nd leg prices)	0.0200	
Reverse Repo account		113.0000
Reverse Repo Interest Adjustment account		5.2388

The balances in respect of the Reverse Repo Interest Adjustment Account and Reverse Repo Price adjustment account at the end of the second leg of reverse repo

in these accounts are transferred to Repo Interest Income Account. In order to analyse the balances in these two accounts, the ledger entries are shown below:

Reverse Repo Price Adjustment Account

Debit		Credit	
Difference in price of 1st & 2nd leg	0.0200	Balance to Repo Interest Income a/c.	0.0200
Total	0.0200	Total	0.0200

Reverse Repo Interest Adjustment Account

Debit		Credit	
Broken period interest for the 1st leg	5.1435	Broken period interest for the 2nd leg	5.2388
Balance carried forward to Repo Interest Income Account	0.0953		
Total	5.2388	Total	5.2388

Reverse Repo Interest Income Account

Debit		Credit	
Difference between the 1st & 2nd leg prices	0.0200	Balance from Reverse Repo Interest Adjustment account	0.0953
Balance carried forward to P & L account	0.0753		
Total	0.0953	Total	0.0953

4. Additional accounting entries to be passed on a Repo / Reverse Repo transaction on a coupon bearing security, when the accounting period is ending on an intervening day.

Transaction Leg →	1st leg	End of accounting period	2nd leg
Dates →	**19 Jan 03**	**21 Jan 03***	**22 Jan 03**

The difference in the clean price of the security between the first leg and the second leg should be apportioned upto the Balance Sheet date and should be shown as Repo Interest Income / Expenditure in the books of the seller / buyer respectively and should be debited / credited as an income / expenditure accrued but not due. The balances under Income / expenditure accrued but not due should be taken to the balance sheet

The coupon accrued by the buyer should also be credited to the Repo Interest Income account. *No entries need to be passed on " Repo / Reverse Repo price*

adjustment account and Repo / Reverse repo interest adjustment account". The illustrative accounting entries are shown below:

a) Entries in Seller's books on January 21, 2003

Account Head	Debit	Credit
Repo Interest Income account [Balances under the account to be transferred to P & L]		0.0133 (Notional credit balance 0.0133 in the Repo Price Adjustment Account by way of apportionment of price difference for two days i.e. upto the balance sheet day)
Repo interest Income accrued but not due	0.0133	

*21 January, 2003 is assumed to be the balance sheet date

b) Entries in Seller's books on January 21, 2003

Account Head	Debit	Credit
Repo interest income	0.0133	
P & L a/c		0.0133

c) Entries in Buyer's Books on January 21, 2003

Account Head	Debit	Credit
Repo interest income accrued but not due	0.0502	
Repo Interest Income account [Balances under the account to be transferred to P & L]		0.0502 (Interest accrued for 3 days of Rs. 0.0635* - Apportionment of the difference in the clean price of Rs. 0.0133)

*For the sake of simplicity the interest accrual has been considered for 2 days.

d) Entries in Buyer's Books on January 21, 2003

Account Head	Debit	Credit
Repo interest income account	0.0502	
P& L a/c		0.0502

The difference between the repo interest accrued by the seller and the buyer is on account of the accrued interest forgone by the seller on the security offered for repo.

B. Repo/ Reverse Repo of Treasury Bill

1. Details of Repo on a Treasury Bill

Security offered under Repo	GOI 91 day Treasury Bill maturing on 28 February, 2003	
Price of the security offered under Repo	Rs.96.0000	**(1)**
Date of the Repo	19 January, 2003	
Repo interest rate	7.75%	
Tenor of the repo	3 days	
Total cash consideration for the first leg	96.0000	**(2)**
Repo interest	0.0612	**(3)**
Price for the second leg	(2)+(3) = 96.0000 + 0.0612 = 96.0612	
Cash consideration for the 2nd leg	96.0612	

2. Accounting for seller of the security

We assume that the security was held by the seller at the book value (BV) of Rs.95.0000

First leg Accounting:

	Debit	Credit
Cash Repo Account	96.0000	95.0000 (Book value)
Repo Price adjustment account		1.0000 (Difference between BV & repo price)

Second Leg Accounting

Repo Account Repo Price adjustment account	95.0000 1.0612 (the difference between the BV and 2nd leg price)	
Cash account		96.0612

The balances in respect of the Repo Price Adjustment Account at the end of the second leg of repo transaction are transferred to Repo Interest Expenditure Account. In order to analyse the balances in this account, the ledger entries are shown:

Repo Price Adjustment account

Debit		Credit	
Difference in price for the 2nd leg	1.0612	Difference in price for the 1st leg	1.0000
		Balance carried forward to Repo Interest Expenditure account	0.0612
Total	1.0612	Total	1.0612

Repo Interest Expenditure Account

Debit		Credit	
Balance from Repo Price Adjustment account	0.0612	Balance carried forward to P & L a/c.	0.0612
Total	0.0612	Total	0.0612

The Seller will continue to accrue the discount at the original discount rate during the period of the repo.

3. Accounting for buyer of the security

When the security is bought, it will bring its book value with it. Hence market value is the book value of the security.

First leg Accounting:

	Debit	Credit
Reverse Repo Account	96.0000	
Cash account		96.0000

Second Leg Accounting

	Debit	Credit
Cash account	96.0612	
Repo Interest Income account (Difference between the 1st and 2nd leg prices)		0.0612
Reverse Repo account		96.0000

The Buyer will not accrue for the discount during the period of the repo.

4. Additional accounting entries to be passed on a Repo / Reverse Repo transaction on a Treasury Bill, when the accounting period is ending on an intervening day.

Transaction Leg →	1st leg	B/S date	2nd leg
Date →	19 Jan.03	21 Jan.03*	22 Jan.03

***21 January, 2003 is assumed to be the balance sheet date**

a. Entries in Seller's books on January 21, 2003

Account Head	Debit	Credit
Repo Interest Expenditure account (after apportionment of repo interest for two days) [Balances under the account to be transferred to P & L]	0.0408	
Repo interest expenditure accrued but not due		0.0408

b. Entries in Seller’s books on January 21, 2003

Account Head	Debit	Credit
Repo interest expenditure account		0.0408
P & L a/c	0.0408	

c. Entries in Buyer's Books on January 21, 2003

Account Head	Debit	Credit
Repo interest income accrued but not due	0.0408	
Repo Interest Income account [Balances under the account to be transferred to P & L]		0.0408

d. Entries in Buyer's Books on January 21, 2003

Account Head	Debit	Credit
Repo interest income account	0.0408	
P & L a/c		0.0408

APPENDIX

Part A: List of circulars consolidated by the Master Circular

No.	Circular No.	Date	Subject	Para No.
1.	FIC No. 984-994/ 01.02.00 / 91-92	June 23, 1992	Investment Portfolio- Transactions in Securities	Entire Circular
2.	FIC No. 493-503/ 01.02.00 / 92-93	January 4, 1993	Investment Portfolio- Transactions in Securities	Entire Circular
3.	FIC.No. 937-947/ 01.02.00/93-94	April 22, 1994	Monitoring the Activities of Subsidiaries / Mutual Funds	Entire Circular
4.	FIC. No. 551 / 01.08.00/ 95-96	January 24, 1996	Investment Portfolio- Transactions in Securities- Role of Brokers	Entire Circular
5.	FIC. No. 198 / 01.08.00/ 96-97	September 2, 1996	Investment Portfolio- Transactions in Securities	Entire Circular
6.	FIC. No. 7 / 01.08.00/ 96-97	February 19, 1997	Investment Portfolio- Transactions in Securities	Entire Circular
7.	DBS.FID.No.23 / 01.08.00/ 97-98	January 20, 1998	Investment Portfolio- Transactions in Securities- Role of Brokers	Entire Circular
8.	DBS.FID.No.40 / 01.08.00/ 98-99	April 28, 1999	Issue of Sub-Ordinated Debt for Raising Tier II Capital	Entire Circular
9.	DBS.FID.No.C-9 / 01.02.00/ 2000-01	November 9,2000	Guidelines for Classification and Valuation of Investments	Entire Circular
10.	DBS.FID.No. C-10 / 01.02.00/ 2000-01	November 22, 2000	Investment Portfolio- Transactions in Securities- Role of Brokers	Entire Circular
11.	DBS.FID.No. C-6 / 01.02.00/ 2001-02	October 16, 2001	Guidelines for Classification and Valuation of Investments- Clarifications/ Modifications	Entire Circular
12.	DBS.FID.No. C-10 / 01.02.00/ 2001-02	February 1, 2002	Treatment of Restructured accounts- Clarifications	Para 8 of Annex
13.	DBS.FID.No. C-2 / 01.02.00/ 2002-03	July 18, 2002	Transactions in Government Securities	Entire Circular
14.	DBS.FID No. C-3 / 01.02.00/2002-03	July 22, 2002	Guidelines for classification and valuation of investments - Clarifications	Entire Circular
15.	IDMC/PDRS/ 3432 / 10.02.01/2002-03	February 21, 2003	Ready Forward Contracts	Entire Circular
16.	IDMC.3810 / 11.08.10 / 2002-03	March 24, 2003	Guidelines for uniform accounting for Repo / Reverse repo transactions	Entire Circular
17.	IDMC. MSRD. 4801 / 06.01.03/2002-03	June 3, 2003	Guidelines on Exchange Traded Interest Rate Derivatives	Entire Circular
18.	DBS.FID No.C-16 /01.02.00/2002-03	June 20, 2003	Investment Portfolio - Transactions in Securities - Audit Review and Reporting System - Modifications	Entire Circular
19.	DBS.FID.No.C-1/01.02.00/2003-04	July 1, 2003	Trading in Government of India Securities on Stock exchanges	Entire Circular
20.	DBS.FID.No.C-11 / 01.02.00 /2003-04	January 8, 2004	Final guidelines on investment by the FIs in debt securities	Entire Circular

Part B: List of other circulars containing instructions related / relevant to Investments now superceded

No.	Circular No.	Date	Subject
1.	FIC. No. 338 / 01.08.00/ 95-96	November 3, 1995	Investment Portfolio- Classification of Investments Under ' Permanent and Current' Category
2.	DBS.FID. No. 22 / 01.02.00/ 97-98	January 15, 1998	Settlement of Institutional Transactions in the Depository
3.	DBS.FID. No. 3 / 01.02.00/ 99-00	August 10, 1999	Permission to Undertake Ready Forward Transactions
4.	DBS.FID. No. C-15 / 01.02.00/ 99-00	April 8, 2000	Ready Forward Transactions
5.	DBS.FID.No. C-16 / 01.02.00/ 2001-02	May 14, 2002	Ready Forward Contracts- through CCI Ltd.