Report of Informal Group on Valuation of Banks' Investments Portfolio

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CHAPTER 1 : INTRODUCTION

BACKGROUND

1.1 Till 1990 the accounting treatment of investments by banks in India was left to the choice of individual banks. Since banks considered investment portfolio as a part of the regulatory framework than an item which could generate income they preferred to merely allocate the stipulated portion of their net demand and time liabilities for investments in approved securities which were generally held to maturity.

1.2 The Ghosh Committee on the Final Accounts of the banks had recognized that a significant portion of a bank's portfolio would be held till maturity and therefore it would be necessary to provide for diminution in the value of such investments based on market quotations. The Committee therefore, recommended that a bank's investment portfolio should be bifurcated into two parts, viz. "permanent" investment and "current" investment and it would not be necessary for banks to provide for diminution in the value of permanent investment but that full provision needs to be made for the depreciation in the value of current investment.

1.3. Since then various developments have taken place in the banking sector and Reserve Bank has also come out with a variety of guidelines such as those on Income Recognition, Asset Classification, Provisioning and other related matters including Accounting Standards for investments. Instructions have also been issued on bifurcation of investments into "Permanent" and "Current" categories and RBI has made it explicit that its endeavour is to reduce the proportion of investments under permanent category in the banks' portfolio with a view to achieving 100 per cent marking to market of portfolios of commercial banks. Since 1996, RBI has been issuing valuation guidelines to the banks to facilitate finalisation of their balance sheets.

1.4 In the meantime, the Committee on Banking Sector Reforms (Narasimham Committee Report II) has also recommended that the process of marking to market should be expedited so that in the next three years the entire investment portfolio is marked to market. The Committee has further recommended that banks should satisfy half yearly disclosure requirements. This essentially will require banks to do half yearly valuation of their securities portfolio. Further, since many banks are entering the capital markets for raising capital, they will be required to list their shares in the Stock Exchanges.

1.5 There is no denying the fact that during the last five years Indian banking system in general has witnessed a sea change. Banks today are on a better footing than before in terms of capital

adequacy, investment management, income recognition, asset classification, provisioning for non performing assets and other related matters. On the other hand, the trading in the securities market has improved in terms of turn over and maturities dealt with.

1.6 A segment of the market feels that in view of these developments and taking the international practices into consideration there is a need for a review of the existing stipulations on bifurcation of banks' investments into "permanent" and "current" and the desirability of implementation of the proposal to mark to market their enter portfolios by the year end 2001. So also, the desirability of need for RBI's issuance of guidelines on YTM for balance sheet purpose needs to be examined especially in view of the fact that the year end valuation of securities without an appropriate income recognition has been resulting in volatility in the profits of banks thus giving a distorted picture of the banking scenario in India.

1.7 Further, Governor raised a query on the implications of marking 100 per cent of their portfolio of investments to market by banks in India against the practices prevalent, the world over. Consequent upon this, DG(R) desired that an internal group be set up to examine the above issue. Accordingly a group comprising Chief General Managers of Department of Banking Operations and Development (DBOD) and Internal Debt Management Cell, the Adviser-in-charge, Monetary Policy Department (MPD), the Legal Adviser, Legal Department as members and General Manager, IDM Cell as the Convenor was constituted in May 19, 1999.

ISSUES EXAMINED

1.8 The issues examined by the Group are as under:

i) The desirability of bifurcation of investment portfolio into "current" and "permanent" categories and issuance of stipulations by RBI;

ii) Implications of 100 per cent marking to market of their "current" portfolio by banks;

iii) Issuance of YTM Guidelines by RBI to banks at the end of every financial year;

iv) Valuation treatment to be followed in respect of non-SLR and other investments.

METHODOLOGY

1.9 The Group had several rounds of discussions amongst its own members of the Group and also with representatives of Arthur Andersen who have acquired international experience in the area as auditors of banks. The group discussed various issues related to 100 per cent marking to market of Banks' portfolio in the Indian context. In the light of the international practices in respect of portfolio valuation by banks the Group examined various options for implementation.

1.10 The group wishes to place on record its appreciation for the contribution made by Mrs. Shyamala Gopinath, Chief General Manager, Department of External Investments and Operations, Shri C.R.Muralidharan, General Manager and Shri A.K.Khound, Dy.General

Manager, both from DBOD and Shri K.D.Zacharias, Jr.Legal Adviser from Legal Department in giving shape to the Report. Shri S.C.Misra, Asst.General Manager prepared minutes of the meetings held.

CHAPTER SCHEME

1.11 Chapter 1 is introduction. Chapter 2 explains Valuation of Banks' Investments : Present Policy. Chapter 3 provides details on Valuation of Banks' Investments: International Practices. Chapter 4 gives an in depth Examination of Valuation of Banks' Investments. Chapter 5 is Summary of Recommendations.

CHAPTER 2

VALUATION OF BANKS' INVESTMENTS - PRESENT POLICY

BACKGROUND

2.1 It has been the endeavour of RBI to make the banks increasingly mark their investments in "approved securities" to market. i.e. earmark a higher portion of their investments in the "current" category to facilitate valuing all the investments on fully "marked to market" basis. From the very beginning, the investments in other than the approved security segment were to be marked to market. Marking the approved securities to market was necessary in view of the fact that the banks continued to hold a large number of low yielding Government securities purchased by them during the high SLR regime.

2.2 To begin with, banks were not to keep more than 70 per cent of their investments in permanent category from the accounting year 1992-93. As a further step to moving towards valuing all investments on fully "marked to market" basis, it was the endeavor of the Reserve Bank to reduce the proportion of investments under permanent category in the banks' portfolios. Accordingly, the ratio of permanent investment was brought down to 60 per cent for the year ended March 31, 1996. The ratio was further brought down to 50 per cent for the year ended March 31, 1997 40 per cent for the year ending March 31, 1998 and 30 per cent for the year ending March 31, 1999. It was further decided that banks should mark to market 75 per cent of their SLR portfolio for the year ending March 31, 2000. New private sector banks are required to "mark to market" their entire investments of "approved" securities as at end of March 1997 and thereafter.

2.3 Thus at present all approved securities, excluding the permanent category (at percentage stipulated by RBI) have to be marked to market. All the other securities (like PSU bonds, shares , units etc.) have also to be fully marked to market. In case banks choose to mark to market a greater share (than mandated by RBI), they could do so; however they cannot subsequently roll back the higher level to the mandated minimum levels suggested by RBI.

BIFURCATION

2.4 The banks were advised by RBI that for the financial year 1992-93, they should not keep more than 70 per cent of their approved investments in the "Permanent" category. i.e. current investments had to be at least 30 per cent of the total approved portfolio. Banks were also advised that while acquiring any new security it should be clearly identified as "Current" or "Permanent".

2.5 Transfer of securities from one category to another was permitted provided that the case was properly documented and prior approval of the Board of Directors was obtained. In case of transfer from "Current" to "Permanent" category, where market value was less than book value, potential losses had to be recognized immediately.

GENESIS OF YTM METHOD

2.6 Prior to March 1994 , the debt securities classified under "Current Category" in the balance sheets of banks were valued at market price or cost whichever was lower as per instructions of DBOD. Since market prices/quotations in respect of all the securities were not available, banks were following their own method for valuation in respect of unquoted securities and there was no uniformity among banks on the method of valuation. To obviate this problem DBOD decided in February 1994 that Indian Banks' Association (IBA) in consultation with the Institute of Chartered Accountants of India (ICAI) should evolve a uniform method for valuation of Government and other approved securities by banks. Accordingly, IBA and ICAI suggested that the absence of market quotations, the Government and other approved securities in current category could be valued as per the yield to maturity (YTM) method. Thus, the practice of prescribing YTMs by the RBI emerged essentially due to non availability of traded prices/quotations for all the securities.

PERMANENT CATEGORY

2.7 The permanent category investments should be valued at cost unless it was more than the face value, in which case the premium had to be amortized over the period remaining for maturity of the security. This implied that depreciation, if any, need not be provided for in respect of securities held under "permanent" category.

2.8 Any gain on sale of securities in the permanent category of investments should be first taken to the Profit and Loss account and thereafter it could be appropriated to "Capital Reserve". On the other hand, where the cost price is less than the face value, the difference should be ignored and should not be amortized or taken to income account since the amount represents unrealized gain.

CURRENT CATEGORY

2.9 Valuation of Government Securities in the "Current" category should be done as per market quotations as on the date of the balance sheet. Where market quotations are not available valuation of the Government securities should be made on the basis of the yields as suggested by RBI. The RBI guidelines require banks to value each category scrip wise and aggregate the depreciation/appreciation, category wise. While net appreciation is required to be ignored, net depreciation is to be provided. The valuation norms also require banks to provide for net depreciation in any one category without setting it off against net appreciation in any other category. Thus net depreciation required to be provided for in any one category should not be reduced on account of net appreciation in any other category. The yields prescribed by RBI are also applied to State Government securities and Government guaranteed bonds.

2.10 It has recently been decided that the excess provision towards depreciation on investments should be appropriated to "Investment Fluctuation Reserve Account" instead of Capital Reserve Account and should be shown as a separate item in Schedule 2 – "Reserves and Surpluses" under the head "Revenue and other Reserves" and will be eligible for inclusion in Tier II capital. With

a view to recognising the nature of the Reserve it has further been decided that the existing amount of excess provision towards depreciation on investments held under Capital Reserve Account may be transferred to the "Investment Fluctuation Reserve Account" as on March 31, 1999 and it could be utilized to meet future depreciation requirement on investment in securities.

VALUATION OF NON-SLR PORTFOLIO

2.11 RBI has also been prescribing mechanics for valuation for other instruments such as PSU bonds, shares, debentures, mutual fund units, investments in subsidiaries and sponsored institutions, treasury bills of all maturities, commercial papers, recapitalisation bonds etc. In the case of taxable non priority sector PSU bonds, 2 per cent above the YTM rates of Government Securities are applied. For tax free non priority sector PSU bonds, 1 per cent below the YTM rates of Government securities are applied while for tax free priority sector PSU bonds 2 per cent YTM rates of Government securities is applied. In the case of debentures wherever stock exchange quotations are available the debentures should be valued accordingly. For unquoted debentures, the basis of valuation is carrying cost if interest is serviced regularly or valuation as per NPA norms of loan assets if interest is not serviced regularly.

2.12 Investments in subsidiaries and sponsored institutions are to be valued at carrying cost (book value) on a consistent basis.

100 PER CENT MARKING TO MARKET

2.13 As stated earlier the Committee on Banking Sector Reforms (Narasimham Committee Report II) recommended that the process of marking to market should be expedited so that in the next three years the entire investment portfolio is marked to market. The Committee's focus has been on strengthening the balance sheet of banks and projecting the true picture as far as the real worth of their investments is concerned. The Committee felt that this would be of great advantage to them as many banks are entering the capital markets for raising capital and would be required to list their shares in the Stock Exchanges.

2.14 The avowed policy of 100 per cent marking to market of banks' investment has the objectives of ensuring that these assets are reflected at their true market value on the one hand and the portfolio once marked to market may encourage banks to start trading in these securities. This might eventually lead to a deeper and vibrant debt market. The main reasons for advocating 100 per cent marking to market of approved securities for SLR purpose are as under:

> 2.14.1 The bank balance sheets will disclose the true value of assets held as part of investment portfolio. Thus, 100 per cent marking to market would be a step which should be encouraged from the prudential angle.
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> 2.14.2 The Indian banks are under close watch by the international community including rating agencies and total transparency by way of marking to market would be taken as a welcome feature by them.

2.14.3 Marking to market of the entire portfolio eliminates the incentive for imprudent financial decision which takes into account only current yield and not appreciation/depreciation.

2.14.4 It would help elimination of the tendency to push some of the low yielding securities into "permanent" category investments on which there could be a large valuation loss.

2.14.5 Marking to market would encourage trading in securities held in the hitherto classified "permanent" category. The objective of making a market in long term debt will thus be achieved if all securities without any differentiation are marked to market.

2.15 The views expressed above were accepted in principle and sought to be implemented. From the foregoing discussion it could be gathered that RBI had suggested bifurcation of investments of banks aiming at 100 per cent marking to market of their securities to strengthen the balance sheets of banks on the one hand and to give a boost to the securities market on the other. This was important in view of the fact that banks held large number of low yielding securities in their approved securities portfolio during the high SLR regime and trading could activate the secondary market for government securities.

2.16 Later, the Bank has gone a step further and has been issuing valuation guidelines. The valuation norms suggested have been most conservative as it ignored all unrealised gains while requiring provisions being made for any depreciation in the value of securities.

CHAPTER 3

VALUATION OF BANKS' INVESTMENTS: INTERNATIONAL PRACTICES

3.1 In this Chapter international practices in regard to valuation of portfolios are examined. The countries considered for examination include the USA, U.K., Germany, Japan, Australia, Netherlands and South Africa. Country experiences reveal that there are divergent experiences and in most countries there does not exist the practice of banks' marking their entire portfolio to market.

3.2 The main guiding principle of investment valuation is management's intended holding period. Accordingly securities intended to be held for shorter periods are either marked to market or valued at the lower of cost or market value and securities intended to be held for longer periods are usually carried at cost.

3.3 In most countries some amount of flexibility is available in deciding on bifurcation of securities in their portfolio for holding and trading. Banks in major developed countries like the U.S.A and the U.K. generally hold securities under two or three broad accounts viz. "Trading Account", "Investment Account" and "Securities held for Sale Account". While securities held under trading account are marked to market securities held under investment account are mostly valued at cost.

IASC VALUATION NORMS

3.4 International Accounting Standards Committee (IASC) has laid down its valuation norms and currently valuation of investments is governed by its IAS 25 entitled "Accounting for Investments" . As per IAS 25, current investments are those readily realisable and are intended to be held for not more than one year. These are valued at either market value or the lower of cost and market value. Long term investments are investments other than current investments. These are valued at either cost, revalued amounts or in the case of marketable equity securities, the lower of cost and market value determined on a portfolio basis.

U.S.A

3.5 In the US.A the Federal Reserve has not prescribed any percentage pattern of holdings of securities for banks. The banks are, in fact, free to hold securities as they like. Accordingly banks in the U.S. have followed accounting systems as laid down in the Statement of Financial Accounting Standards No.115. Thus investments are valued broadly on the basis of three main categories. The classification is same as indicated under IAS 25.

3.6 Bank of America, for instance holds its securities exactly under the same categories as above. The securities classified under the category for trading are those securities which are traded frequently and also marked to market . The securities which are held to maturity are those securities where the intention of the bank is to hold till maturity and they are not marked to

market. They are accounted for at face value and reported in the balance sheet at amortized cost. The securities available for sale are those securities where the intention of the bank is neither to trade nor to hold till maturity. These securities are valued at the fair value which is determined by reference to the best available source of current market quotations or other data relative to current value.

3.7 The accounting system of Citi bank is, however different from that of Bank of America. Citi bank holds its securities under the heads (I) Held to maturity and (ii) Trading Account. The securities which are held to maturity are valued at amortised cost and those for trading are marked to market on monthly basis.

3.8 The Chase Manhattan Bank has classified their investments into three types. The first segment comprising securities held to maturity includes securities that the corporation has positive intent and ability to hold to maturity. The second segment which includes securities available for sale are those securities which may be sold in response to anticipation of changes in interest rates and they are carried at fair value. The third segment includes debt and equity instruments which are carried at their estimated fair value.

U.K.

3.9 As in the case of Federal Reserve in the U.S.A Bank of England in the U.K. also has not prescribed any percentage for holding under permanent or current category. For instance, Standard Chartered Bank holds securities under the categories of investment account and trading account. The securities held under trading account are marked to market on a daily basis. Securities under investment account are valued at cost less any amount written off to reflect diminution in value.

3.10 On the other hand HSBC Holdings Plc holds its debt securities under three categories comprising securities for investment, securities held for hedging and others. The securities which are held for investments are valued at cost less provisions if any and are held on a continuous basis. Securities held for hedging are valued in the same manner as the liabilities which are being hedged. Investments under the other category are valued at market price.

GERMANY

3.11 In Germany Deutsche Bundes Bank has also not issued any guidelines on as to how much of percentage of securities is to be held under permanent category or under current. Banks have flexibility and freedom to decide on the allocations.

3.12 Deutsche Bank for instance has classified its investments into two categories. Viz. Trading Portfolio and Secretariat Portfolio. While securities held in the trading portfolio are to be marked to market investments under the Secretariat Portfolio are held permanently and valued at lower of cost or market value.

3.13 Dresdner Bank makes a distinction between securities held in trading portfolios and those held as reserve liquidity. In both cases the securities are carried as current assets and are strictly

valued by type of security at the lower of moving average values and market value on the balance sheet date.

AUSTRALIA

3.14 Reserve Bank of Australia has not fixed any percentage to be held under permanent or current category. It is left to individual banks to hold securities in trading account or investment account. Securities held under trading account are marked to market and those held under investment account are valued at cost.

JAPAN

3.15 In Japan like other developed countries there is no stipulation in regard to permanent and current investments as far as banks are concerned. In Japan marketable securities are valued at lower of cost or market value, basis of valuation being optional and applied to securities on an individual basis. Sakura Bank in Japan carries "Listed Trading Account Securities" at the lower of cost or market value. "Other Trading Account" securities are carried at cost, cost being determined by the moving average method. Trading Account securities held by overseas consolidated subsidiaries are carried mainly at market value. It is understood that securities under "Trading Account" constitute less than 10 per cent of the total portfolio.

NETHERLANDS

3.16 ABN Amro Holding NV holds securities in the "Trading "Portfolio at market value. "Interest Earning" securities are held in the investment portfolio at redemption value.

BELGIUM

3.17 In Belgium the General Bank trading securities are valued at their market price if there is a liquid market. In the absence of a liquid market they are valued at the market or estimated value or cost whichever is lower. The financial fixed assets, on the other hand, are held at cost.

SOUTH AFRICA

3.18 The Reserve Bank of South Africa has not prescribed any percentage to be marked to market. Banks follow the Generally Accepted Accounting Practice (GAAP) under which all Government securities under Trading Portfolio have to be marked to market. Government securities held under "Investment Portfolio " have to be valued at lower of cost or net realizable value. All Government securities qualify as collateral for accommodation from Central Bank. Such securities are valued on a daily basis according to the yield curve of the Central bank.

OBSERVATIONS

3.19 From the foregoing discussion it could be observed that there is no practice of issuing instructions on bifurcation of investments of banks into permanent and current by central banks anywhere. Nor do they issue valuation guidelines due perhaps to existence of well developed

debt markets.. The banks themselves, however, broadly categorize securities in their portfolios depending on their nature and the purpose they are intended to and accounting is done as per international practices.

3.20 The IAS 25 will be superseded by IAS 39 from January 1, 2001 and as per the modified version valuation of investments will be as under:

1. Current or For trading: Assets acquired principally for the purpose of trading and generating a profit from short term fluctuations in price or dealer's margin will be classified under this category and they will be valued at fair value;

2. Held to maturity : They are those assets that have fixed or determinable payments and fixed maturity, and which an enterprise has the positive intent and ability to hold to maturity. Such investments are classified under this category of investments and carried at amortised cost subject to a test for impairment;

3.Available for sale: These assets are those that are not loans and receivables originated by the enterprise, held to maturity investments, or financial assets held for trading. Such financial assets are valued at fair value.

Fair value is the amount for which an asset could be exchanged between a knowledgeable willing buyer and a knwledgeable, willing seller in an arm's lenth transaction.

Those assets which are to be valued at fair value, the enterprise will have a single enterprise-wide option to either:

- recognise the entire adjustment in net profit or loss for the period or

- recognise the net profit or loss for the period- only those changes in fair value-relating to securities held for trading with the value changes in non-trading securities reported in equity until the financial asset is sold, at which time the realised gain or loss is reported in net profit or loss.

The Accounting Treatment will be effectively as under:

Option I:

Trading Portfolio – Gain or loss adjusted in profit and loss
Available for sale securities – Gain or loss adjusted to equity (Reserves)

Option II

Trading Portfolio - Gain or loss adjusted in profit and loss
Available for sale securities – Gain or loss adjusted in profit and loss

3.21 Accounting practices indicate that securities categorized under trading category are marked to market while those held to maturity are accounted for at face value. The securities which do not fall in either category as indicated above are priced at " fair value" which is determined by reference to the best available source of current market quotations.

CHAPTER 4

AN EXAMINATION OF VALUATION OF BANKS' INVESTMENTS

4.1 In the light of the developments discussed in the foregoing Chapters it is felt there is need for a review of existing policies relating to valuation of banks' investments in India. The issues which need examination are as indicated in Para 1.8 above. These comprise:

1. The desirability of bifurcation of investment portfolio into "current" and "permanent" categories and issuance of stipulations by RBI;

2. Implications of 100 per cent marking to market of their entire investment portfolio by banks;

3. The need for issuance of YTM Guidelines by RBI to banks end of every financial year;

4. Valuation treatment to be followed in respect of non-SLR and other investments.

FLEXIBILITY IN BIFURCATION OF INVESTMENTS

4.2 There is a strong case for providing freedom and flexibility to banks in deciding on classification of their investments in accordance with international norms for reasons elaborated in the following paragraphs.

4.2.1 In the Indian context the bifurcation of portfolio of investments by banks into "current" and "permanent" was initially suggested with a view to making balance sheets of banks show their real worth on the one hand and at the same time encourage trading with a view to giving a boost to the government securities market. The situation has since changed and the bank balance sheets are more transparent than before.

4.2.2 Also today there are capital adequacy measures in place along with comprehensive instructions from RBI on income recognition, asset classification, provisioning and other related matters. So also, the Government securities market has come a long way and the turn over in the secondary market has grown many fold thus there being no need for continuance of such bifurcation with a view to promoting trading of government securities in secondary market.

4.2.3 There is need for uniformity in valuation practices followed by all market players. Introduction of international norms in respect of banks would pave way for this in future. A comparative chart of valuation practices is appended in this regard for comparison.

Category of institutions	Valuation Practices followed

1. Financial Institutions	In the case of financial institutions like IDBI, ICICI etc. there is no stipulation to bifurcate the investment portfolio into current and permanent categories. IDBI treats its entire portfolio as permanent investment while ICICI treats it as current.
2. Insurance Companies	In the case of insurance companies like LIC the government securities are basically valued at cost. An estimate of the market price is also made and if there is any appreciation, it is ignored. If there is any depreciation, the auditors set it off against the appreciation in the equity portfolio. If the appreciation in the equity portfolio is not enough to adjust, the depreciation is ignored and the securities are valued at cost.
3. Provident Funds	There is no set guideline for valuation of the investment portfolio of provident funds. The securities are valued mostly at cost. If the cost exceeds the face value, the excess amount is either amortized over the life of the security or the difference is charged to the income account at the maturity of the security.
4. Non banking Financial Companies	In the case of Non banking Financial companies investments in securities are required to be classified as current and long term investments. Current investment means an investment which is readily realizable and is intended to be held for not more than one year. Investments other than current investment are long term investments. Quoted current investments are valued at cost or market value whichever is lower. Investments in unquoted government securities are valued at carrying cost.

4.2.4 . Banks could have generally been given the freedom to categorize their holdings of investments in the manner they like as long as they follow the laid down international standards. This would encourage them to acquire securities of various maturities rather than depending on securities of short term nature with a view to reducing the impact of depreciation when yields firm up. It would also enable banks to hold some securities permanently and on a longer term basis and account for them as permanent investments.

4.2.5 Advocating immediate reversal of the existing practice of bifurcating the portfolio by banks and a return to total freedom and flexibility may not however be desirable in the Indian context especially when RBI has already indicated that banks would need to have the entire investments under current category marked to market over a period of time. Any such reversal also may be viewed as a slippage and may not be favoured internationally.

4.2.6 Keeping the above developments in view the Group suggests that Banks may classify their entire investments in Government and other "approved" securities under three categories viz. "Held for Trading", "Available for sale" and "permanent". The "permanent" component should not exceed 25 per cent of total investment in approved securities. However, banks have the freedom to classify the entire investment portfolio in Government and other "approved" securities as "Held for Trading" or "Available for sale". Such a classification is expected to give them the required flexibility while also achieve the desired objectives of introducing international standards as far as valuation is concerned.

4.2.7 The proposal will also enable banks to account securities "Held for Trading" or "Available for sale" under lower maturity bucket for the purpose of Assets Liabilities Management.

IMPLICATIONS OF MARKING THE INVESTMENTS ENTIRELY TO MARKET

4.3 As per the existing guidelines Banks must have achieved a current-permanent ratio of 70:30 by end March 1999 and the proposal is to have 100 per cent marking to market of SLR portfolio. Figures available indicate that some banks have already marked their entire SLR portfolio to market while others have more than achieved this target. Since banks are already holding securities in excess of SLR requirements to the extent of Rs.71,446 crore they are expected to mark even these excess SLR holdings to market. In the Indian context while marking 100 per cent to market may be a desirable feature it may not achieve any objective as far as a bank is concerned due to the accounting policies followed by them while at the same time could cause volatility in their profits.

In the first place, stipulations on 100 per cent marking to market of the securities portfolio may result in uncertainty of profitability of operations as it would have a bearing on prices of securities as on March 31st of each year. Higher yields at the end of the year for the purpose of balance sheets of banks could result in making provisions and depreciation thus having telling effects on their profits. Yields to maturities announced by RBI during the last four years from

1996 to 1999 as shown in the Annexure indicate a steep rise first and thereafter a fall. The severity of the impact of this could have been reduced if banks could have some flexibility in categorizing their investments.

A solution sometime offered is to take average prices of securities for a longer period of time for arriving at acceptable prices of securities for the purpose of balance sheets. This suggestion was not acceptable as averaging of prices of securities is not a practice accepted internationally.

Secondly, the international practice in marking to market recognises booking both loss or gain in the income account. Since investment in Government securities constitutes almost 33 per cent of the total assets of the banking system, not recognising the unrealised gain in assets would lead to distortion in the profitability of banks.

Thirdly, there is always apprehension that aberrations in prices witnessed by the government securities market due to excessively volatile conditions prevalent in the money and foreign exchange markets could adversely affect the RBI suggested YTM for valuation of securities thus resulting in hardship to banks for no reason.

Fourthly, the treatment of not recognising the incomes earned by way of appreciation is asymmetric when considered from the point of view of asset liabilities management where a bank while deriving no gain from a fall in interest rate on a fixed rate liability the appreciation available on investments on the same count could have compensated for the resultant loss if the same could be taken as an income.

Fifthly, The International Accounting Standard IAS 39 which will become operational from January 1, 2001 also stipulates that the unrealised gain/loss in respect of securities in Trading Account may be recognised in the income account. The group discussed the issue and felt that it may be prudent to transfer such gains to a Reserve Account (after paying tax) through income account which will not be available for distribution as in the case of revaluation of immovable assets.

4.4 In view of the foregoing developments and the proposal of the Group to classify their investments in Government and other "approved " securities into three categories viz. "Held for Trading", "Available for sale" and "permanent" it is also suggested that banks may mark to market their holdings under the first two categories. Further, under present guidelines securities in the "current" category are required to be valued category-wise. While net appreciation in any category is ignored, net depreciation in a category is provided for. The Group recommends that banks in India should follow the international norm of recognizing both appreciation and depreciation in valuation of "current" securities in profit and loss account for the period. The Group's specific recommendations on valuation accordingly are as under:

> 4.4.1 Securities classified in "Held for Trading" category should be marked to market on a monthly if not more frequent basis. While the depreciation should be recognized in the income account , appreciation, if any, being unrealized, should be appropriated to the "Investment Fluctuation Reserve" through Income Account.

4.4.2 Securities in "Available for sale" category should also be marked to market at the year end or at more frequent intervals as decided by the Board of Directors. The gain or loss on revaluation may be taken to the Investment Fluctuation Reserve Account without routing through the income account. In the event that balance in the reserve account is insufficient, provision for depreciation should be made in the income account. In the event of sale/realization of any investment from this category , the actual amount realized may be recognized in the income account.

4.4.3 Securities held in "permanent" category can be carried at cost unless it was more than the face value, in which case the premium has to be amortized over the period remaining for maturity of the security.

4.4.4 Banks may also be given freedom to shift investments from one category to another with the consent of the Board of Directors.

ISSUANCE OF YTM GUIDELINES BY RBI

4.5 At present RBI prescribes YTMs for valuation of Central Government Securities where market quotations/RBI prices are not available. The issue whether RBI should continue to prescribe such YTM was discussed and the consensus was that RBI need not prescribe such rates for the following reasons:

a) A large number of Government securities across the maturity spectrum are traded now in the secondary market and the securities traded cover almost 70-80 per cent of the total holdings by banks;

b) Rates quoted/traded at NSE and data in respect of SGL transactions are readily available on a daily basis;

c) Where no price/quote is available banks may value the securities by referring to the yields of bonds of similar maturities traded/quoted.

VALUATION OF OTHER NON-SLR INVESTMENTS

4.6 RBI has been issuing guidelines in respect of other non-SLR PSU bonds and other Non SLR Non PSU bonds. Specific YTM rates linked to the sovereign bond yields were also issued for valuation as on March 31, 1999. This was done by comparing the rates at which the bench mark bonds were issued by financial institutions. Since bonds issued by non-PSUs are valued at carrying cost there is a disincentive to invest in them. The matter was discussed and a view was taken that RBI need not prescribe the methodology for valuation of all the non approved securities. These could be valued at fair value by individual banks taking the yield spread between the sovereign yield and the yield on the concerned bonds/similar bonds of relevant maturities into consideration.

4.7 All the recommendations above could be made applicable to all banks including new private sector banks.

CHAPTER 5:

SUMMARY OF RECOMMENDATIONS

The summary of the recommendations of the Group are as under:

5.1 Banks may classify their entire investments in Government and other "approved" securities under three categories viz. "Held for Trading", "Available for sale" and "permanent". The "permanent" component should not exceed 25 per cent of total investment in approved securities. However, banks have the freedom to classify the entire investment portfolio in Government and other "approved" securities as "Held for Trading" or "Available for sale". (Para 4.2.6)

5.2 Securities classified in "Held for Trading" category should be marked to market on a monthly if not more frequent basis. While the depreciation should be recognised in the Income Account, appreciation, if any, being unrealised, should be appropriated to the "Investment Fluctuation Reserve" through Income Account.(Para 4.4.1)

5.3 Securities in "Available for sale" category should also be marked to market at the year end or at more frequent intervals as decided by the Board of Directors. The gain or loss on revaluation may be taken to the Investment Fluctuation Reserve Account without routing through the income account. In the event that balance in the reserve account is insufficient, provision for depreciation should be made in the income account. In the event of sale/realisation of any investment from this category , the actual amount realised may be recognised in the income account.(Para 4.4.2)

5.4 Securities held in "permanent" category can be carried at cost unless it was more than the face value, in which case the premium has to be amortised over the period remaining for maturity of the security.(Para 4.4.3)

5.5 Banks can shift investments from one category to the other only with the approval of the Board of Directors. (Para 4.4.4)

5.6 As Government securities across a wide maturity spectrum are traded and market prices are available, RBI need not prescribe financial year-end YTM. Banks may refer to the prices available in SGL transactions, NSE trades/quotes, price list of RBI at the year-end and value the securities to the satisfaction of auditors. (Para 4.5)

5.7 RBI also need not prescribe the methodology for valuation of all the non-approved securities comprising PSU bonds and non-PSU bonds and debentures and they could be valued at "fair value" by individual banks taking the yield spread between the sovereign yield and the yield on the concerned bonds/similar bonds into consideration.(Para 4.6)

5.8 All the recommendations made above could be made applicable to all banks including new private sector banks.(Para 4.7)

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