# Reserve Bank of India: Master Circular

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## Valuation Examination Syllabus

**Reserve Bank of India and Regulations under Foreign Exchange Management Act, 1999:**

- FEMA (Transfer or Issue of Security by a Person Resident Outside India), Regulations, 2017;
- Foreign Direct Investment (Pricing Guidelines);
- Direct Investment by Residents in Joint Venture/ Wholly Owned Subsidiary abroad;
- Prudential Norms for Classification, Valuation and
- Operation of Investment Portfolio by Banks; Guidelines on Sale of Stressed Assets by Banks

# CLASSIFICATION OF INVESTMENT

# Classification of Investment

- Held to Maturity
- Available for Sale
- Held for Trading

# Held to Maturity

Banks should decide the category of the investment at the time of acquisition

- The securities acquired by the banks with the intention to hold them up to maturity will be classified under 'Held to Maturity (HTM)'.
- Investments included under HTM category upto **25 per cent of their total investments** is allowed except:
  - The excess comprises only of SLR securities and
  - The total SLR securities held in the HTM category is not more than 22.0 per cent of their Demand and Time Liabilities (DTL) as on the last Friday of the second preceding fortnight.

Banks may hold the following securities under HTM:

SLR Securities upto the extent permitted.

Non-SLR securities included under HTM as on September 2, 2004.

Re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in Investment portfolio.

Investment in the equity of subsidiaries and joint ventures (a Joint Venture would be one in which the bank, along with its subsidiaries, holds more than 25 percent of the equity).

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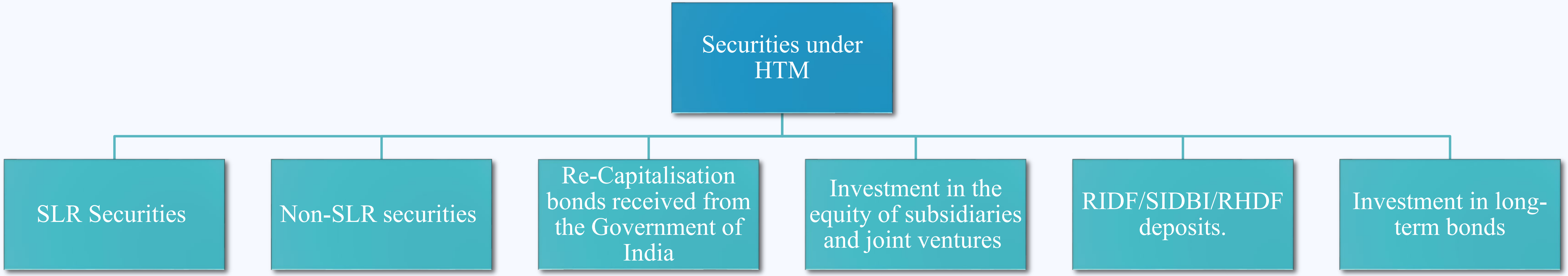
- **Profit on sale** of investments in this category should be first taken to the Profit & Loss Account, and thereafter be appropriated to the ‘Capital Reserve Account’.
- **Loss on sale** will be recognised in the Profit & Loss Account.

# Held to Maturity



# Valuation of Held to Maturity Security

- Investment at the **Acquisition cost.**
- If acquisition cost more than FV, premium should be amortised over the period remaining to maturity.
- No need to be marked to market yearly.
- Situations where the impairment has to be made:
    - the company has defaulted in repayment of its debt obligations.
    - he loan amount of the company with any bank has been restructured.
    - the credit rating of the company has been downgraded to below investment grade.
    - the company has incurred losses for a continuous period of three years and the net worth has consequently been reduced by 25% or more.

In the case of impairment, the bank should obtain a valuation of the investment by a **reputed/qualified valuer** and make provision for the impairment.

## Held for Trading

- The securities acquired by the banks with the intention to trade by taking advantage of the short-term price/interest rate movements will be classified under 'Held for Trading (HFT).
- These securities are to be sold within 90 days.
- Profit or loss on sale of investments will be taken to the Profit & Loss Account.

**Valuation**

- It will be marked to market at monthly or at more frequent intervals

## Available for Sale

- The securities which do not fall within the above two categories will be classified under 'Available for Sale (AFS)
- Profit or loss on sale of investments will be taken to the Profit & Loss Account.

**Valuation**

- It will be marked to market at quarterly or at more frequent intervals

# Shifting amongst Category

**HTM → AFS/HFT**

- Only with the approval of the Board of Directors & once in a year except when permitted by RBI.

**AFS → HFT**

- Only with the approval of their Board of Directors/ ALCO/ Investment Committee.

**HFT → AFS**

- Generally not allowed. Permitted only in exceptional circumstances

**AFS / HFT → HTM**

- The shares should be transferred at the lower of book value or market value.

# Valuation

| S.No | Investment | Valuation |
|---|---|---|
| 1. | Debentures/ Bonds | Yield to Maturity (YTM) |
| 2. | Zero coupon bonds | Carrying Cost i.e. acquisition cost plus discount accrued |
| 3. | Preference Shares | Yield to Maturity (YTM) |
| 4. | Equity Shares | **Listed:** Marked to market preferably on a daily basis<br>**Unlisted:** Break up Value |
| 5. | Mutual Funds Units | **Listed:** Stock Exchange quotations<br>**Unlisted:** Latest re-purchase price |
| 6. | Commercial Papers | Carrying Cost |
| 7. | Securities issued by Securitisation Company (SC) / Reconstruction Company (RC) | **Lower** of:<br>The redemption value or<br>Net Book Value |

# Master Circular – Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks

# Investment Policy

- Banks should frame Internal Investment Policy Guidelines and obtain the **Board's approval**.

Inclusion in Investment Policy:

- Primary Dealer (PD) : PD business undertaken by the bank will be limited to dealing, underwriting and market–making in Government Securities.

The following guidelines are to be kept in view by the banks:

(a) Banks may sell a government security already contracted for purchase

  (a) The purchase contract is confirmed prior to the sale

  (b) The purchase contract is guaranteed by Clearing Corporation of India Ltd. (CCIL)

(b) The settlement of all outright secondary market transactions in Government Securities is being done on a standardised T+1 basis but where at least one of the parties is an FPI, will be settled only on T+2 basis

( c) Banks desirous of making investment in equity shares/ debentures should observe the following guidelines:

- Build up adequate expertise in equity research
- Formulate a transparent policy
- The decision in regard to direct investment in shares, convertible bonds and debentures should be taken by the Investment Committee set up by the bank's Board.

STRIPS

Ready Forward Contracts in Government Securities

Transactions through Subsidiary General Ledger A/c

Engagement of brokers

Use of Bank Receipts

Retailing of Government Securities

Internal Control System

Audit, Review and Reporting of Investment Transactions

## Separate Trading of Registered Interest and Principal Securities (STRIPS)

- Stripping is a process of converting periodic coupon payments of an existing Government Security into tradable zero-coupon securities, which will usually trade in the market at a discount and are redeemed at face value

- Reconstitution is the reverse process of stripping

# Ready Forward Contracts in Government Securities

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 State Governments.

Ready Forward contracts can be entered into only by:

- Persons or entities maintaining a Subsidiary General Ledger (**SGL**) account with RBI, Mumbai
- maintain gilt accounts (i.e gilt account holders) with a bank or any other entity (i.e. the custodian) permitted by the Reserve Bank to maintain Constituent Subsidiary General Ledger (CSGL) account with its PDO, Mumbai

➢ All ready forward contracts shall be reported on the Negotiated Dealing System (NDS)

➢ All ready forward contracts shall be settled through the SGL Account/CSGL Account maintained with the RBI

➢ Securities purchased under the ready forward contracts shall not be sold during the period of the contract except by entities permitted to undertake short selling.

➢ Re-repo is permitted in government securities, including state development loans and Treasury Bills, acquired under reverse repo

# Transactions through SGL account

Following instructions should be followed by banks for **purchase / sale of securities through SGL A/c**, under the Delivery Versus Payment System wherein the transfer of securities **takes place simultaneously** with the transfer of funds **(No overdraft facility).**

- All transactions in Government Securities for which SGL facility is available should be put through SGL account only.
- Under no circumstances, a SGL transfer form issued by a bank in favour of another bank should bounce for want of sufficient balance of securities otherwise the (selling) bank which has issued the form will be liable to the following penal action against it at a rate of **3 percentage points above** the SBI Discount and Finance House of India's (SBIDFHI) call money lending rate
- The SGL transfer form received by purchasing banks should be deposited in their SGL account immediately, i.e., the date of lodgment of the SGL Form with the Reserve Bank shall be within one working day after the date of signing of the Transfer Form.
- 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 bank with the Reserve Bank.

## Use of Bank Receipt (BR)

The banks should follow the following instructions for issue of BRs:

- No BR should be issued under any circumstances in respect of transactions in Government Securities for which SGL facility is available.
- BR may be issued for ready transactions only, under the following circumstances:
  - The scrips are yet to be issued by the issuer and the bank is holding the allotment advice
  - The security is physically held at a different centre
  - The security has been lodged for transfer / interest payment

- No BR should remain outstanding for more than 15 days otherwise the BR should be deemed as dishonoured
- BR should be redeemed only by actual delivery of scrips

# Internal Control System

The banks' managements should ensure that there are adequate internal control and audit procedures for ensuring proper compliance of the instructions in regard to the conduct of the investment portfolio

- There should be a clear functional separation of (i) trading, (ii) settlement, monitoring and control and (iii) accounting.
- All SGL/CSGL account holders should adhere to the FIMMDA code of conduct while executing trades on NDS-OM and in the OTC market
- Banks are required to report OTC trades in Commercial Papers (CPs) and Certificate of Deposits (CDs) and OTC repo trades in corporate debt securities
- In case of investment in shares, the surveillance and monitoring of investment should be done by the Audit Committee of the Board
- The internal audit department should audit the transactions in securities on an ongoing basis

# Engagement of brokers

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

- Transactions between one bank and another bank i.e. intra bank should not be put through the brokers' accounts.
- 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 & the broker is not obliged to disclose the identity of the counterparty to the deal.
- Banks should prepare a panel of approved brokers which should be reviewed annually or more often if so warranted.
- A limit of 5% of total transactions through brokers (both purchase and sales) entered into by a bank during a year should be treated as the aggregate upper contract limit for each of the approved brokers.
- The concurrent auditors who audit the treasury operations should scrutinise the business done through brokers also

# Audit, review and reporting of investment transactions

- Banks should undertake a half-yearly review (as of March 31 and September 30) of their investment portfolio, which should, apart from other operational aspects of investment portfolio
- A copy of the review report put up to the Bank's Board should be forwarded to the Reserve Bank (concerned Regional Office of DBS, RBI) by May 15 and November 15 respectively.
- Treasury transactions should be separately subjected to concurrent audit by internal auditors and the results of their audit should be placed before the CMD of the bank once every month.

# INVESTMENT IN NON-SLR SECURITIES

**Guidelines**

- Banks may henceforth make investments only in those securities which adhere to the **SEBI regulations** with respect to the disclosure norms for issue of debt securities
- Banks should not invest in Non-SLR securities of original maturity of **less than one-year**, other than Commercial Paper and Certificates of Deposits and NCDs which are covered under RBI guidelines.
- Banks should undertake usual due diligence in respect of investments in non-SLR securities
- Banks must not invest in **unrated** non-SLR securities except companies engaged in infrastructure activities but within the ceiling of 10 per cent for unlisted non-SLR.
- Bank's investment in **unlisted** non-SLR securities should not exceed 10 per cent of its total investment in non-SLR securities as on March 31, of the previous year except investment in Securitisation papers issued for infrastructure projects, and bonds/debentures issued by Securitisation Companies (SCs) and Reconstruction Companies (RCs). If the bank breaches the limit then the bank **would not** be allowed to make further investment in non-SLR securities .

## LIMITS ON BANKS' EXPOSURE TO CAPITAL MARKETS

- The aggregate exposure of a bank to the capital markets in all forms (both fund based and non-fund based) **should not exceed 40 per cent** of its net worth as on March 31 of the previous year.

- Within this overall ceiling, the bank’s direct investment in shares, convertible bonds/ debentures, units of equity-oriented mutual funds and all exposures to Venture Capital Funds (VCFs) [both registered and unregistered] should not exceed **20 per cent of its net worth**.

A bank’s Board of Directors is free to adopt a lower ceiling for the bank, keeping in view its overall risk profile and corporate strategy.

## INVESTMENTS IN LONG TERM BONDS ISSUED BY BANKS FOR FINANCING OF INFRASTRUCTURE AND AFFORDABLE HOUSING

- An investing bank’s investment in a specific issue of such bonds will be capped at 2% of the investing bank’s Tier 1 Capital or 5% of the issue size, whichever is lower.
- An investing bank’s aggregate holding in such bonds will be capped at 10% of its total Non-SLR investments.
- Not more than 20% of the primary issue size of such bond issuance can be allotted to banks.
- Banks cannot hold their own bonds.

# GUIDELINES ON SALE OF STRESSED ASSETS BY BANKS

# Policy on Sale of Stressed Assets

Banks shall recognise incipient stress in loan accounts, immediately on default, by classifying such assets as **Special Mention Accounts (SMA)**

| SMA Sub-categories | Basis for classification – Principal or interest payment or any other amount wholly or partly overdue between |
|---|---|
| SMA-0 | 1-30 days |
| SMA-1 | 31-60 days |
| SMA-2 | 61-90 days |

Banks shall report credit information, including classification of an account as SMA to Central Repository of Information on Large Credits (**CRILC**), on all borrowers having aggregate exposure of **₹ 50 million** and above with them.

# Policy on Sale of Stressed Assets

Following Important points to be considered:

- Identification of stressed assets for sale shall be top-down
- **Once in a year**, the board shall identify and list internally the specific financial assets identified for sale
- All assets under **“Doubtful Assets”** should be reviewed by the board/board committee on periodic basis
- Prospective buyers can be SCs/RCs or other banks/NBFCs/FIs
- Minimum time to be given for due diligence to the prospective buyer of the assets is **2 weeks**
- The value of stressed assets can be **internal or external**. However, in case of exposures beyond Rs.50 crore, banks shall obtain 2 external valuation reports

The threshold for the investment by banks in Security Receipts backed by stressed assets sold by it, to be eligible for progressive provisioning is **10%.**

# Thank you

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