Audit of Treasury Operations of Banks

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Treasury operations have become more significant and complex today than what it was few years back. The role played by the technology and the rapid changes in the financial sector has brought in more flexibility in the funds deployment by banks. The dynamism with which the Treasury Market moves needs to be fully understood by the Auditor and hence he needs specialized skills to conduct audit of treasury operations more so in an environment of integrated treasury operations where the forex and domestic treasury are fully integrated in the Banks. Due to spurt in credit off take and lower yield in G-Sec the Investment Portfolio is witness downward trend most of the banks for the last twelve months and there will be pressure on the Treasury to maintain the performance which have been very good till last year. Looking back at the past events especially the pre liberalization era and non-automation of investment functions especially SGL transactions, the achievements made by the bank in the last few years in these areas needs commendation. The RBI has introduced prudential norms for income recognition, valuation and provisioning norms for investments. This coupled with the IRAC norms introduced for advances, had a deep impact on the financials of the banks for the year 1992-93 and continued for few more years. However, coupled with the technological developments, good internal governance and adherence to the RBI norms strictly, the Indian banks could take up the challenge posed on the industry and responded in a more positive manner which has resulted in total turnaround in the style of functioning of the banks in India. The Reserve Bank has issued several guidelines over the last 12-13 years and these guidelines have a great bearing on the audit of banks. Hence, the auditors have a tremendous responsibility and need to update themselves quite frequently to cope up with the dynamism of the treasury market of today.

As per the RBI guidelines, Banks 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. Further, 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) by 15 November and 15 May respectively.

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 Chairman and Managing Director of the bank once every month and major irregularities observed in these reports and the position of compliance thereto shall be incorporated in the half yearly review of the investment portfolio.

1. Investment Policy:

As per RBI guidelines every bank should frame and implement a suitable investment policy to ensure that operations in securities are conducted in accordance with sound and acceptable business practices. The policy should among other things should take into consideration the following:

a) No sale transaction should be put through without actually holding the security in its investment account i.e. under no circumstances; banks should hold an oversold position in any security. However, banks may sell a government security

already contracted for purchase, provided:

i. the purchase contract is confirmed prior to the sale,
ii. the purchase contract is guaranteed by CCIL or the security is contracted for purchase from the Reserve Bank and,
iii. the sale transaction will settle either in the same settlement cycle as the preceding purchase contract, or in a subsequent settlement cycle so that the delivery obligation under the sale contract is met by the securities acquired under the purchase contract

b) All the transactions put through by a bank, either on outright basis or ready forward basis and whether through the mechanism of Subsidiary General Ledger (SGL) Account or Bank Receipt (BR), should be reflected on the same day in its investment account and, accordingly, for SLR purpose wherever applicable.

c) 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/ memoranda put up to the top management seeking approval for putting through the transaction and a separate account of brokerage paid, brokerwise, should be maintained.

d) For issue of BRs, the banks should adopt the format prescribed by the Indian Banks' Association (IBA) and strictly follow the guidelines prescribed by them in this regard. The banks, subject to the above, could issue BRs covering their own sale transactions only and should not issue BRs on behalf of their constituents, including brokers.

e) The banks should be circumspect while acting as agents of their broker clients for carrying out transactions in securities on behalf of brokers.

f) Any instance of return of SGL form from the Public Debt Office of the Reserve Bank for want of sufficient balance in the account should be immediately brought to Reserve Bank's notice with the details of the transactions.

2. Internal Control Systems:

Banks should have strong internal control systems in place considering the various factors such as the volume, volatility, fraud and errors etc. As per the guidelines of the Reserve Bank, banks should have sound internal controls in place as below:

a) There should be a clear functional separation of (i) trading, (ii) settlement, monitoring and control and (iii) accounting. Similarly, there should be a functional separation of trading and back office functions relating to banks' own Investment Accounts, Portfolio Management Scheme (PMS) Clients' Accounts and other Constituents (including brokers') accounts. The Portfolio Management service may be provided to clients, subject to strictly following the guidelines issued by the RBI from time to time. Further, as per the guidelines PMS Clients Accounts should be subjected to a separate audit by external auditors.

b) 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.

Banks should not draw cheques on their account with the Reserve Bank for third party transactions, including inter-bank transactions.

c) Once a deal has been concluded, there should not be any substitution of the counter party bank by another bank 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.

d) 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 account.

e) In the case of transaction relating to PMS Clients' Accounts (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's own Investment Account and the bank is acting only in its fiduciary/ agency capacity.

f) i. Records of SGL transfer forms issued/ received, should be maintained.

ii. Balances as per bank's books should be reconciled at quarterly intervals with the balances in the books of PDOs.

Banks should have strong internal control systems in place considering the various factors such as the volume, volatility, fraud and errors, etc.

If the number of transactions so warrant, the reconciliation should be undertaken more frequently, say on a monthly basis. This reconciliation should be periodically checked by the internal audit department.

iii. Any bouncing of SGL transfer forms issued by selling banks in favour of the buying bank, should immediately be brought to the notice of the Regional Office of Department ofBanking Supervision of RBI by the buying bank.

iv. A record of BRs issued/ received should be maintained.

v. A system for verification of the authenticity of the BRs and SGL transfer forms received from the other banks and confirmation of authorised signatories should be put in place.

g) Banks 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 banks and BRs outstanding for more than one month and a review of investment transactions undertaken during the period.

h) Banks should not draw cheques on their account with the Reserve Bank for third party transactions, including inter-bank transactions. For such transactions, bankers' cheques/pay orders should be issued.

i) In case of investment in shares, the surveillance and monitoring of investment should be done by the Audit Committee of the Board, which shall review in each of its meetings, the total exposure of the bank to capital market both fund based and non-fund based, in different forms as stated above and ensure that the guidelines issued by RBI are complied with and adequate risk management and internal control systems are in place;

j) The Audit Committee should keep the Board informed about the overall exposure to capital market, the compliance with the RBI and Board guidelines, adequacy of risk management and internal control systems;

k) In order to avoid any possible conflict of interest, it should be ensured that the stockbrokers as directors on the Boards of banks or in any other capacity, do not involve themselves in any manner with the Investment Committee or in the decisions in regard to making investments in shares, etc., or advances against shares.

l) The internal audit department should audit the transactions in securities on an on going basis, monitor the compliance with the laid down management policies and prescribed procedures and report the deficiencies directly to the management of the bank.

m) 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. The banks should institute a regular system of monitoring compliance with the prudential and other guidelines issued by the RBI. The banks should get compliance in key areas certified by their statutory auditors and furnish such audit certificate to the Regional Office of Department of Banking Supervision of RBI under whose jurisdiction the HO of the bank falls.

3. Ready Forward Contracts in Government Securities:

The RBI vide notification No. S.O. 131 (E) dated 22nd

January has issued the terms and conditions under which ready forward contract including reverse repo transactions may be entered into as under:

(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 State Governments.

(b) Ready forward contracts can be entered into only with i) persons or entities maintaining a Subsidiary General Ledger (SGL) account with Reserve Bank of India, Mumbai and ii) the following categories of entities who 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 (CSGL) account with its Public Debt Office, Mumbai:
   - i) Any scheduled bank,
   - ii) Any primary dealer authorized by the Reserve Bank of India,
   - iii) 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, d) Any mutual fund registered with the Securities Exchange Board of India, e) Any housing finance company registered with the National Housing Bank, and
   - iv) Any insurance company registered with the Insurance Regulatory and Development Authority.

(c) All persons or entities specified at (ii) 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.

(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.
   - (ii) Buy-back arrangements:
   - (a) Double ready forward deals in Government securities including treasury bills are strictly prohibited.
   - (b) No ready forward and double ready forward deals should be put through even among banks and even on their investment accounts in other securities such as public sector undertakings bonds, units of UTI, etc.
   - (c) Similarly, no ready forward and double ready

forward deals should be entered into in any securities including Government securities, on behalf of other constituents including brokers.

(iii) The guidelines for uniform accounting for Repo / Reverse Repo transactions have also been announced by the Reserve Bank of India.

4. Transactions through SGL account:

The following instructions have been issued by the RBI to be followed by banks 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, therefore, necessary for both the selling bank and the buying bank to maintain current account with the RBI. As no Overdraft facility in the current account would be extended by RBI, adequate balance in current account should be maintained by banks for effecting any purchase transaction.

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 bank in favour of another bank 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 banks should be deposited in their SGL A/cs immediately i.e. the date of lodgment of the SGL Form with RBI shall be within one working day after the date of signing of the Transfer Form. While in cases of OTC trades, the settlement has to be only on 'spot' delivery basis as per Section 2(i) of the Securities Contract Act, 1956, in cases of deals on the recognized 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 bank.

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

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) bank 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 bank 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 3 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 banks, as stipulated in the Reserve Bank's interest rate directive in force, the applicable penal rate to be charged will be 3 percentage points above the prime lending rate of the bank concerned

c) If the bouncing of the SGL form occurs thrice, the bank will be debarred from trading with the use of the SGL facility for a period of 6 months from the occurrence of the third bouncing. If, after restoration of the facility, any SGL form of the concerned bank

All transactions in Govt. securities for which SGL facility is available should be put through SGL Accounts only.

bounces again, the bank 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 bank would be reckoned (against the buying bank 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 bank (against selling bank). 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.)

5. Engagement of Brokers:

As a follow up to the securities scam the RBI issued strict norms for appointment of brokers, types transactions to be put through, settlement etc as below:

a) Transactions between one bank and another bank 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, viz. both fund settlement and delivery of security, should be directly between the banks and the broker should have no role to play in the process.

e) With the approval of their top managements, banks 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. Banks 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 bank 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 bank and the business offered/ brought to the bank by a broker. Banks 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. However, the norm of 5% would not be applicable to banks' dealings through Primary Dealers.

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.

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 bank. 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.

6. Retailing in Government Securities:

The banks are permitted to undertake retailing of Government Securities with non-bank clients subject to the following conditions:

i) Such retailing should be on outright basis and there is no restriction on the period between sale and purchase.
ii) The retailing of Government securities should be on the basis of ongoing market rates/ yield curve emerging out of secondary market transactions.
iii) No sale of Government securities should be effected by banks unless they hold the securities in their portfolio either in the form of physical scrips or in the SGL Account maintained with the Reserve Bank of India.
iv) Immediately on sale, the corresponding amount should be deducted by the bank from its investment account and from its SLR assets.
v) Banks should put in place adequate internal control checks/mechanisms as indicated in paragraph 3.
vi) These transactions should be subjected to concurrent audit by internal auditors/ external auditors and results of their audit should be placed before the CMD of the bank every month. These audit reports are also to be submitted to a separately constituted Cell on supervision of funds management operations in banks in RBI.

7. Issues specific to non-SLR securities:

The phased reduction in SLR percentage has led the banks to deploy their funds in non-SLR securities both in Government Papers as well as subscription to various instruments of private sector. Some of the Investments in the Private Sector became bad leading to heavy provisioning and write off. The Reserve Bank from time to time has imposed restrictions and conditions against indiscriminate investment measures taken up the banks in this regard. As per guidelines of the RBI rating is a must and also it is strongly recommended the securities are listed in the market. The rating also should not be older than one month prior to the date of issue. Also the technical group formed by the RBI has recommended stringent disclosure norms in the offer document. 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. The unlisted non-SLR securities in which banks may invest up to the limits specified above, should comply with the disclosure requirements as prescribed by the SEBI for listed companies.

Bank's investment in unlisted non-SLR securities may exceed the limit of 10 per cent, by an additional 10 per cent, provided the investment is on account of investment in securitization papers issued for infrastructure projects, and bonds/debentures issued by Securitization Companies and Reconstruction Companies set up under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 and registered with RBI. In other words investment exclusively in securities specified in this paragraph could be up to the maximum permitted limit of 20 per cent. Boards of banks should review the following aspects of non-SLR investment at least at quarterly intervals:

a) Total business (investment and divestment) during the reporting period.
b) Compliance with the prudential limits prescribed by the Board for non-SLR investment.
c) Compliance with the prudential guidelines issued by Reserve Bank on non-SLR securities.
d) Rating migration of the issuers/ issues held in the bank's books and consequent diminution in the portfolio quality.
e) Extent of non performing investments in the non-SLR category

8. Reconciliation of Holdings:

Banks should furnish to the Reserve Bank the statement of the reconciliation of bank's investments (held in own Investment account, as also under PMS) as at the end of every accounting year duly certified by the bank's auditors. Further, the statement should be sent to the Reserve Bank within one month from the close of the accounting year.

9. Classification of Investment Portfolio:

As per the RBI guidelines the investment portfolio of a Bank has to be classified under three categories viz. 'Held to Maturity', 'Available for Sale' and 'Held for Trading'. The classification shall be made at the time of acquisition and the decision should be recorded on the investment proposals. However, in the Balance Sheet the investments will

continue to be disclosed as per the existing six classifications as below:

a) Government Securities
b) Other approved securities
c) Shares
d) Debentures & Bonds
e) Subsidiaries/Joint Ventures and
f) Others (CP, Mutual Fund Units, etc.)

i) The securities acquired by the banks with the intention to hold them up to maturity has to be classified under held to maturity.

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

iii) The following investments will be classified under 'Held to Maturity' but will not be counted for the purpose of ceiling of 25% specified for this category:

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

iv) Banks have been allowed in September 2, 2004 to exceed the limit of 25 per cent of total investments under HTM category provided :

a. the excess comprises only of SLR securities, and
b. the total SLR securities held in the HTM category is not more than 25 per cent of their DTL as on the last Friday of the second preceding fortnight.

v) The non-SLR securities held as part of HTM as on September 2, 2004 may remain in that category. No fresh non-SLR securities are permitted to be included in the HTM category, except the following :

a) Fresh re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in their investment portfolio. This will not include re-capitalisation bonds of other banks acquired for investment purposes.
b) Fresh investment in the equity of subsidiaries and joint ventures.
c) RIDF/ SIDBI deposits

vi) To sum up, banks may hold the following securities under HTM category:

a) SLR securities upto 25 per cent of their DTL as on the last Friday of the second preceding fortnight.
b) Non-SLR securities included under HTM as on September 2, 2004.
c) Fresh re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in their investment portfolio.
d) Fresh investment in the equity of subsidiaries and joint ventures (A joint venture would be one in which bank, along with its subsidiaries, holds more than 25 per cent of the equity).
e) RIDF/ SIDBI deposits.

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

Available for Sale & Held for Trading

i) The securities acquired by the banks with the intention to trade by taking advantage of the short term price/ interest rate movements shall be classified under held for trading.
ii) The securities which do not fall within the above two categories are to be classified under available for sale.
iii) The banks 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.
iv) The investments classified under Held for trading category would be those from which the bank expects to

make a gain by the movement in the interest rates/ market rates. These securities are to be sold within 90 days.

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

10. Shifting among Categories:

i) Banks are permitted to shift investments **to/from Held to Maturity** category with the approval of the Board of Directors once a year. Such shifting shall be normally allowed at the beginning of the accounting year. No further shifting to/ from this category shall be allowed during the remaining part of that accounting year.

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

iii) 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 like not being able to sell the security within 90 days due to tight liquidity conditions, or extreme volatility, or market becoming unidirectional. Such transfer is permitted only with the approval of the Board of Directors/ ALCO/ Investment Committee.

iv) 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.

11. Valuation:

The Reserve Bank of India has issued the necessary guidelines for valuation of the securities under all the three categories as below:

Held to Maturity

i) Investments classified under Held to Maturity category need not be marked to market and can 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.

ii Banks have to 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.

Available for Sale

i) The individual scrips in the Available for Sale category shall be marked to market at the quarterly or at more frequent intervals. While the net depreciation under each class should be recognized and fully provided for, the net appreciation under each classification should be ignored. The book value of the individual securities would not undergo any change after the revaluation. Securities under this category shall be valued scrip-wise and depreciation/ appreciation shall be aggregated for each classification. 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.

ii) The provisions required to be created on account of depreciation in the Available for Sale category in any year should be debited to the Profit & Loss Account and an equivalent amount (net of tax benefit, if any, and net of consequent reduction in the transfer to Statutory Reserve) or the balance available in the Investment Fluctuation Reserve Account, whichever is less, shall be transferred from the Investment Fluctuation Reserve Account to the Profit & Loss Account. In the event provisions created on account of depreciation in the Available for Sale category are found to be in excess of the required amount in any year, the excess should be credited to the Profit & Loss Account and an equivalent amount (net of taxes, if any, and net of transfer to Statutory Reserves as applicable to such excess provision) should be appropriated to the Investment Fluctuation Reserve Account to be utilized 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.

Held for Trading

The individual scrips in the Held for Trading category will be marked to market at monthly or at more frequent intervals as in the case of those in the Available for Sale category. The book value of the individual securities in this category would not undergo any change after marking to market.

The equity shares in the bank's portfolio should be marked to market preferably on a daily basis, but at least on a weekly basis. In respect of securities included in any of the three categories where interest/ principal is in arrears, the banks should not reckon income on the securities and should also make appropriate provisions for the depreciation in the value of the investment. The banks should not set-off the depreciation requirement in respect of these non-performing securities against the appreciation in respect of other performing securities.

13. Investment Fluctuation Reserve:

In order to build up of adequate reserves to guard against any possible reversal of interest rate environment in future due to unexpected developments, the RBI has made it compulsory for banks to build up Investment Fluctuation Reserve (IFR) of a minimum of 5 per cent of the Investment Portfolio. IFR should be computed with reference to investments in two categories, viz., "Held for Trading" and "Available for Sale". It will not be necessary to include investment under "Held to Maturity" category for the purpose of computation of IFR. However, banks are free to build up a higher percentage of IFR up to 10 per cent of the portfolio depending on the size and composition of their portfolio, with the approval of their Board of Directors. Transfer to IFR shall be as an appropriation of net profit "below the line" after appropriation to statutory reserve.

13. Market Value:

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

Unquoted SLR securities

Central Government Securities

i) Banks should value the unquoted Central Government securities on the basis of the prices/ YTM rates put out by the PDAI/ FIMMDA at periodical intervals.

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

iii) Treasury Bills should be valued at carrying cost.

State Government Securities

State Government securities will be valued applying the YTM method by marking it up

by 25 basis points above the yields of the Central Government Securities of equivalent maturity put out by PDAI/ FIMMDA periodically.

Other 'approved' Securities

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

Unquoted Non-SLR securities

Debentures/ Bonds

All debentures/ bonds other than debentures/ bonds which are in the nature of advance should be valued on the YTM basis. Such debentures/ bonds may be of different companies having different ratings. These will be valued with appropriate mark-up over the YTM rates for Central Government securities as put out by PDAI/ FIMMDA periodically. The mark-up will be graded according to the ratings assigned to the debentures/ bonds by the rating agencies subject to the following: -

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

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

(c) Where interest/ principal on the debenture/ bonds is in arrears, the provision should be made for the debentures as in the case of debentures/ bonds treated as advances. The depreciation/provision requirement towards debentures where the interest is in arrears or principal is not paid as per due date, shall not be allowed to be set-off against appreciation against other debentures/ bonds. Where the debenture/ bonds is quoted and there have been transactions within 15 days prior to the valuation date, the value adopted should not be higher than the rate at which the transaction is recorded on the stock exchange.

Preference Shares

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

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

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

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

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

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

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

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

Equity Shares

The equity shares in the bank's portfolio should be marked to market preferably on a daily basis, but at least on a weekly basis.

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

Mutual Funds Units

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

Commercial Paper

Commercial paper should be valued at the carrying cost.

Investments in RRBs

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

Investment in securities issued by SC/RC

When banks/FIs invest in the security receipts/passthrough certificates issued by Securitisation Company (SC)/ Reconstruction Company (RC) in respect of the financial assets sold by them to the SC/RC, the sale shall be recognised in books of the banks/FIs at the lower of:

- the redemption value of the security receipts/ passthrough certificates, and
- the NBV of the financial asset.

The above investment should be carried in the books of the bank/FI at the price as determined above until its sale or realisation, and on such sale or realisation, the loss or gain must be dealt with as under:

(i) If the sale to SC/RC is at a price below the net book value (NBV) (i.e. Book value less provisions held), the shortfall should be debited to the profit and loss account of that year.

(ii) If the sale is for a value higher than the NBV, the excess provision will not be reversed but will be utilised to meet the shortfall loss on account of sale of other financial assets to SC/RC.

All instruments received by banks/FIs from SC/RC as sale consideration for financial assets sold to them and also other instruments issued by SC/RC in which banks/FIs invest will be in the nature of non-SLR securities.

Accordingly, the valuation, classification and other norms applicable to investment in non-SLR instruments prescribed by RBI from time to time would be applicable to bank's/FI's investment in debentures/bonds/ security receipts/PTCs issued by SC/RC. However, if any of the above instruments issued by SC/RC is limited to the actual realisation of the financial assets assigned to the instruments in the concerned scheme the bank/FI shall reckon the Net Asset Value (NAV), obtained from SC/RC from time to time, for valuation of such investments.

14. Non performing Investments:

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

A non performing investment (NPI), similar to a non performing advance (NPA), is one where:

(i) Interest/instalment (including maturity proceeds) is due and remains unpaid for more than 90 days.

(ii) The above would apply mutatis-mutandis to preference shares where the fixed dividend is not paid.

(iii) In the case of equity shares, in the event the investment in the shares of any company is valued at Re.1 per company on account of the non availability of the latest balance sheet in accordance with the instructions contained in paragraph 28 of the Annexure to circular DBOD.BP.BC.32/ 21.04.048/ 2000-01 dated October 16, 2000, those equity shares would also be reckoned as NPI.

(iv) If any credit facility availed by the issuer is NPA in the books of the bank, investment in any of the securities issued by the same issuer would also be treated as NPI.

(v) The investments in debentures/bonds, which are deemed to be in the nature of advance would also be subjected to NPI norms as applicable to investments.

State Government guaranteed investments

For the year ending March 31, 2005, investment in State Government guaranteed securities would attract prudential norms for identification of non-performing investments and provisioning, if interest and/or principal or any other amount due to the bank remains overdue for more than 180 days.

With effect from the year ending March 31, 2006, investment in State Government guaranteed securities, including those in the nature of 'deemed advance', will attract prudential norms for identification of non-performing investments and provisioning, when interest/ instalment of principal (including maturity proceeds) or any other amount due to the bank remains unpaid for more than 90 days.

15. Uniform Accounting for Repo / Reverse Repo Transactions Prescribed by RBI

In order to ensure uniform accounting treatment for accounting repo /reverse repo transactions and to impart an element of transparency, uni-

form accounting principles, have been laid down for repo / reverse repo transactions undertaken by all the regulated entities. However, for the present, these norms would not apply to repo / reverse repo transactions under the Liquidity Adjustment Facility (LAF) with RBI.

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 banks should not be classified under **Held to Maturity category.** The first leg of the repo should be contracted at 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.

16. Income Recognition

i) Banks are permitted book income on accrual basis on securities of corporate bodies/ public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the Central Government or a State Government, provided interest is serviced regularly and as such is not in arrears.

ii) Banks may book income from dividend on shares of corporate bodies on accrual basis provided dividend on the shares has been declared by the corporate body in its Annual General Meeting and the owner's right to receive payment is established.

iii) Banks may book income from Government securities and bonds and debentures of corporate bodies on accrual basis, where interest rates on these instruments are pre-determined and provided interest is serviced regularly and is not in arrears.

iv) Banks should book income from units of mutual funds on cash basis.

17. Broken Period Interest

Banks should not capitalise the Broken Period Interest paid to seller as part of cost, but treat it as an item of expenditure under Profit and Loss Account in respect of investments in Government and other approved securities. It is to be noted that the above accounting treatment does not take into account taxation implications and hence the banks should comply with the requirements of Income Tax Authorities in the manner prescribed by them.

18. Dematerialised Holding

Banks have been advised to settle the transactions in securities as notified by Securities and Exchange Board of India (SEBI) only through depositories. Banks were also advised that after the commencement of mandatory trading in demat form, they would not be able to sell the shares of listed companies if they were held in physical form. In order to extend the demat form of holding to other instruments like bonds, debentures and equities, it was decided that, with effect from October 31, 2001, banks, FIs, PDs and SDs would be permitted to make fresh investments and hold bonds and debentures, privately placed or otherwise, only in dematerialized form. Outstanding investments in scrip forms would have to be converted into dematerialised form by June 30, 2002. As regards equity instruments, banks were required to convert all their equity holding in scrip form into dematerialised form by December 31, 2004. ❐

Banks have been advised to settle the transactions in securities as notified by Securities and Exchange Board of India (SEBI) only through depositories. Banks were also advised that after the commencement of mandatory trading in demat form, they would not be able to sell the shares of listed companies if they were held in physical form.