First Notes

The Reserve Bank of India amends the classification and valuation norms for investments held by banks

4 October 2023

First Notes on

Financial reporting

Corporate law updates

Regulatory and other information

Disclosures

Sector

All

Banking and insurance

Information, communication, entertainment

Consumer and industrial markets

Infrastructure and government

Relevant to

All

Audit committee

CFO

Others

Transition

Immediately

Within the next three months

Post three months but within six months

Post six months

Forthcoming requirement

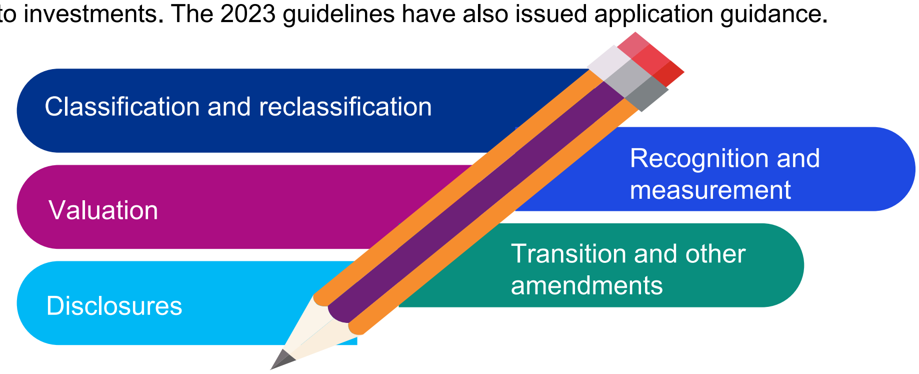
Introduction

Banks[1] are currently required to follow the Master Direction - Classification, Valuation and Operation of Investment Portfolio of Commercial Banks (Directions), 2021 (2021 regulations) for the classification and valuation of their investment portfolio. The 2021 regulations are largely based on a framework introduced in October 2000 that draws on the then prevailing global standards and best practices.

With significant developments in the global standards on classification, measurement and valuation of investments (i.e., the International Financial Reporting Standards (IFRS)), the linkages with the capital adequacy framework as well as progress in the domestic financial markets, there was a need to review and update the 2021 regulations.

Accordingly, on 12 September 2023, the Reserve Bank of India (RBI) issued revised regulatory guidelines on investment classification and valuation - the Master Directions – Classification, Valuation and Operations of Investment Portfolio of Commercial Banks (Directions), 2023 (2023 guidelines).

The key changes in the 2023 guidelines mainly relate to the following matters pertaining to investments. The 2023 guidelines have also issued application guidance.



(Source: KPMG in India's analysis, 2023 read with Master Directions – Classification, Valuation and Operation of Investment Portfolio of Commercial Banks (Directions), 2023 issued by RBI on 12 September 2023)

The 2023 guidelines would be applicable from **1 April 2024**.

This first note aims to provide an overview of the key changes in the 2023 guidelines and how these changes conform with the Indian Accounting Standards (Ind AS) (which are largely aligned with IFRS). We have also summarised some of the key clarifications from the application guidance.

[1] All commercial banks (excluding RRBs)

Overview of the key changes

The following sections set out the key requirements covered in the 2023 guidelines, and the key differences from the 2021 regulations.

A. Classification and reclassification

Classification of investments

The 2023 guidelines have introduced certain key changes with respect to the classification criteria of investments by banks. These are given in the table below:

Key requirements of the 2023 guidelines	Distinction from the 2021 regulations
Classification of investments - Banks should **classify their entire investment portfolio** (except investments in their own subsidiaries, joint ventures and associates) under three categories –Held to Maturity (HTM), Available for Sale (AFS) and Fair Value through Profit and Loss (FVTPL)[2] - All **Investments in own subsidiaries, joint ventures and associates**[3] would be held in a distinct category - which is separate from other investment categories (i.e., HTM, AFS and FVTPL)	Banks are currently required to classify their entire investment portfolio (including SLR securities and non-SLR securities) under three categories, viz., Held to Maturity (HTM), Available for Sale (AFS) and Held for Trading (HFT). Investments in equity of subsidiaries and joint ventures would be eligible for inclusion in HTM category.

The basis for classification of investments in HTM, AFS and FVTPL is given below:

Key requirements of the 2023 guidelines	Distinction from the 2021 regulations
Basis for classification as HTM ***HTM securities:*** Securities that fulfil the following conditions would be classified under HTM: - The security is acquired with the objective of holding it till maturity, i.e., the financial assets are held with the objective to collect the contractual cash flows, and - The contractual terms give rise to cash flows that are Solely Payments of Principal and Interest (SPPI criterion) on principal outstanding on the specified dates. ***SPPI criterion*** Investments in securitisation notes, other than the equity tranche, would be considered to meet the SPPI criterion if the tranche meets certain conditions[4]. The 2023 guidelines have also identified certain instruments that would not meet the SPPI criterion and thus, would not be eligible for classification either as HTM or AFS[5]. ***Limit on HTM*** The 2023 guidelines do not place any limit on investments that can be made under the HTM category.	***HTM securities:*** The 2021 regulations prescribe certain securities, the investments in which would be eligible for inclusion in HTM. These include SLR[6] securities, certain non-SLR securities, recapitalisation bonds received from the Government of India, equity of subsidiaries and joint ventures, long-term bonds issued by infrastructure companies, unquoted securities of category I and II Alternative Investment Funds (AIFs) for a certain period. ***Limit on HTM*** Currently, investments under the HTM category should not exceed 25 per cent of a bank's total investments.

[2] Banks should decide regarding the category of investment before or at the time of acquisition of the investment, and should properly document the same

[3] Subsidiaries, associates and joint ventures have been defined in accordance with the Accounting Standards- subsidiaries in accordance with AS 21, *Consolidated Financial Statements*, associates in accordance with AS 23, *Accounting for Investments in Associates in Consolidated Financial Statements* and joint venture in accordance with AS 27, *Financial Reporting of Interests in Joint Ventures*

[4] The conditions include – the contractual terms of the tranche (without looking through to the underlying pool of financial instruments) gives rise to cash flows that meet the SPPI criterion, the underlying pool of financial instruments meet the SPPI criterion, the credit risk of the tranche is equal to or lower than the credit risk of the combined underlying pool of assets

[5] These include, instruments with compulsorily, optionally or contingently convertible features, instruments with contractual loss absorbency features, instruments whose coupons are not in the nature of interest, certain preference shares, and equity shares (for which an irrevocable option of measuring them at AFS has not been elected.)

[6] SLR- Statutory Liquidity Ratio

Key requirements of the 2023 guidelines	Distinction from the 2021 regulations
Basis for classification as AFS ***AFS securities:*** Securities that fulfil the following conditions would be classified under AFS: - The security is acquired with the objective that is achieved by both, collecting contractual cash flows and selling securities, and - The contractual terms of the security meet the SPPI criterion[7]. ***Irrevocable option to classify equity instrument as AFS*** On initial recognition, a bank may make an irrevocable election to classify an equity instrument that is not held with the objective of trading under AFS[8].	Currently, AFS is a residual category. The securities which do not fall under HTM or HFT categories are classified under AFS. However, quoted securities of Category I and II AIFs; and equity, debentures and other financial instruments acquired by way of conversion of outstanding principal and/or interest amount are always classified in the AFS category.

Key requirements of the 2023 guidelines	Distinction from the 2021 regulations
Basis for classification as FVTPL ***FVTPL securities:*** FVTPL is a residual category, thus securities that do not qualify for inclusion in HTM or AFS would be classified under FVTPL[9] ***Separate HFT subcategory*** Held for Trading (HFT) would be a **separate investment subcategory within FVTPL.** The 2023 guidelines have prescribed specific requirements basis which banks may classify investments in the HFT subcategory ***Maximum period of holding investments*** The FVTPL category or the HFT sub-category **do not** stipulate a period within which investments in that category need to be sold	The 2021 regulations have an HFT category (and not an FVTPL category). Securities acquired with the intention to trade by taking advantage of the short-term price/ interest rate movements would be classified under HFT. ***Maximum period of holding investments*** Investments classified under HFT should be sold within 90 days.

Reclassification between investment categories

The following changes have been issued with regard to reclassification between investment categories:

Key requirements of the 2023 guidelines	Distinction from the 2021 regulations
Reclassifications between measurement categories Under the 2023 guidelines: - Reclassification after transitioning[10] would be permitted only in exceptional circumstances[11]. Such reclassification would require a prior approval of the Board of Directors and the department of supervision of RBI[12] - Reclassification should be applied prospectively from the reclassification date and banks must disclose the details of such reclassification (including the reclassification adjustments) in the notes to the financial statements *(The accounting treatment on reclassification of investments from one category to another, is given in Annexure 1 to the First Notes)*	As per the 2021 regulations: - ***Reclassification from HTM:*** Banks can shift investments to/from HTM category once a year- with the approval of the Board of Directors. Additional shifting during the year would require RBI approval - ***Reclassification from AFS to HFT:*** This is permitted with the approval of the Board of Directors of the bank/Asset Liability Committee (ALCO)/Investment Committee - ***Reclassification from HFT to AFS:*** Shifting of investments from HFT to AFS is not permitted[13].

[7] These would also include debt securities held for ALM purpose, meeting the SPPI criterion, where the bank's intent is flexible w.r.t. holding till maturity or selling before maturity
[8] The 2023 guidelines further clarify that dividend income on such equity instruments should be recognised in the Profit and Loss Account
[9] FVTPL category would include equity shares of companies (other than subsidiaries, joint ventures of associates and equity which are irrevocably classified at AFS), units of mutual funds, AIFs, REITs, InvITs, securitisation notes which represent the equity tranche, certain bonds and debentures the payment of which is linked to the movement in a particular index, etc.
[10] At the time of transition, banks would be required to reclassify their investment portfolio as on 31 March 2024, in accordance with the provisions of the 2023 guidelines
[11] Reclassification would include reclassification from/to HFT
[12] Permission for reclassification would be given in rare circumstances, wherein the bank could demonstrate that such reclassification is necessitated by a significant change in the way in which it proposes to manage a group of investments
[13] However, this reclassification would be permitted in exception circumstances

Key clarifications provided by the application guidance

Classification of investments

- **Classification of similar securities:** Similar securities (including SLR and non-SLR securities) even if acquired at the same point of time or in the same lot, can be classified under different categories if acquired with different objectives. The objectives should be clearly established and documented before or at the time of acquisition.

  For example, if the objective with which a security is acquired is to manage everyday liquidity needs, then the bank would need to routinely sell those securities before maturity. In such cases, assuming the security meets the SPPI criteria, it should be classified under AFS (rather than HTM). On the other hand, a security acquired for meeting the HQLA requirements of the LCR framework[14] need not necessarily be classified under AFS (and can instead be classified as HTM) if the bank intends to liquidate such investment only when facing a liquidity stress.
- **LCR securities:** Securities held to comply with the LCR[15] requirements are not inconsistent with HTM classification. However, if the bank intends to sell securities to meet the regulatory objective, and the value of the securities is significant[16], such securities would not meet the criteria to be classified under HTM.
- **SPPI criterion:** Some of the general aspects with respect to the SPPI criteria are:
  - Cash flows under the SPPI criteria should be consistent with a basic lending arrangement (where time value of money and credit risk are the most significant elements). It is to be noted that regulated interest rate would be considered as a proxy for the time value of money element
  - Contractual cash flows that introduce exposure to risk or volatility that is unrelated with a basic lending arrangement[17] are inconsistent with SPPI criterion
  - In case of foreign currency denominated securities, banks should evaluate for the SPPI criterion in the currency in which the investment is denominated
  - A hybrid financial asset with an embedded derivative, should be tested in its entirety for the SPPI criterion rather than separating the embedded derivative from the instrument
  - A hedged item and a derivative should be assessed separately for classification. The hedged item would be classified basis the 2023 guidelines, and the derivative would be accounted for as per the Guidance Note on Accounting for Derivative Contracts.
- **Clarification for specific securities**
  - Basel III compliant AT 1 and Tier 2 instruments would not meet the SPPI criterion[18] and cannot be classified under HTM or AFS
  - The cash flows on inflation index bonds could be considered to meet the SPPI criterion, since the interest rate on the instrument reflects real interest
  - Securities with step-up and step-down interest rates would meet the SPPI criterion where interest represents consideration only for the time value of money, the credit risk associated with the principal amount outstanding during a particular period of time, other basic lending risks and costs as well as profit margin[19]
  - Subordinated securities may not necessarily fail the SPPI criteria, since such instruments generally carry higher interest rates, which may generally be attributable to the additional credit risk borne by the holders
  - Securities that pay an inverse floating interest rate do not meet the SPPI criterion
  - Contractual cash flows from units of investment funds such as Mutual Funds, AIFs, etc. generally do not meet the SPPI criterion. No look through approach is envisaged in such cases
  - Contractual cash flows from security receipts, pass through certificates or other securities issued by Asset Reconstruction Companies would not meet the SPPI criterion[20].

Reclassification of investments

The reclassification date would be the first day of the first reporting period following the supervisory permission allowing reclassification of a financial asset[21].

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[14] As part of post Global Financial Crisis (GFC) reforms, Basel Committee on Banking Supervision (BCBS) had introduced Liquidity Coverage Ratio (LCR), which requires banks to maintain High Quality Liquid Assets (HQLAs) to meet 30 days net outgo under stressed conditions

[15] This includes where a proportion of assets is held by companies to be monetised through repo or outright sale to test the scalability of the investments

[16] The application guidance provides a threshold of significant as exceeding five per cent of the opening carrying value of the HTM portfolio

[17] Such as exposure to change in equity price or commodity price

[18] This is because the contractual terms of the securities permit or require the issuer to impose losses on the holder- even if the probability of imposing such a loss is low

[19] For e.g., a security with an interest rate that is reset to a higher rate if the debtor misses a particular number of payments is likely to meet SPPI criterion because of the relationship between missed payments and an increase in credit risk. On the other hand, a security with an interest rate that is reset to a higher rate if a specified equity index reaches a particular level shall not meet SPPI criterion

[20] This is because these cash flows are predicated on recoveries from the underlying asset, and may not strictly represent payment of principal and interest on the principal amount outstanding

[21] For e.g., an entity with a reporting year-end of 31 March might get permission to reclassify its investment portfolio in August. If the bank prepares and publishes quarterly results, it should apply the old classification up to 30th September and, as of 1st October ('reclassification date'), reclassify all affected investment and apply the new classification prospectively from that date

Our comments

Classification of investments

- ***Alignment with Ind AS***: The 2023 guidelines are largely aligned with the principles of Ind AS regarding the classification of investments. As per Ind AS 109, *Financial Instruments,* on initial recognition, a financial asset is classified into one of the three primary measurement categories based on the business model within which the asset is held (i.e., held to collect or held to collect and sell) and the contractual cash flow characteristics of the asset (i.e., SPPI criterion). The three categories in which the financial assets are classified under Ind AS 109 are:
  - Amortised cost (financial assets are classified under amortised cost if the business model is held to collect and the financial assets meet the SPPI criterion). This is akin to the HTM category stipulated in the 2023 guidelines.
  - Fair Value through Other Comprehensive Income (FVOCI) (financial assets are classified under FVOCI if the business model is held to collect and sell, and the financial assets meet the SPPI criterion). This is akin to the AFS category stipulated in the 2023 guidelines, and
  - Fair Value Through Profit and Loss (FVTPL) (this is a residual category in Ind AS 109). This is akin to the FVTPL category stipulated in the 2023 guidelines.

  Additionally, like Ind AS 109, the 2023 guidelines also provide holders of equity instruments with an irrevocable option to initially recognise an equity instrument at FVOCI in certain circumstances.
- ***Classification of SLR securities***: The 2023 guidelines lay down the principles for classification of investments in HTM, AFS and FVTPL, and the categorisation is no longer in accordance with the nature of the investment (i.e. whether they are SLR investments or non-SLR investments). Accordingly, non-SLR investments, which were permitted to be classified in HTM only in certain cases, would now be permitted to be held in HTM if they satisfy the conditions for classification as HTM.
- ***No maximum holding period for HFT securities***: The 2023 guidelines do not specify the maximum period within which investments classified in the FVTPL category or the HFT sub-category should be sold. As per the 2021 regulations, investments held in the HFT category need to be sold within 90 days. This would effectively reflect the true intent and nature of the bank's trading portfolio and not necessarily be influenced by rules defining the eligibility to this category as per the 2021 regulations.
- ***Higher investments expected in bonds:*** The 2021 regulations have currently placed a limit on investments that can be held in the HTM category, thus banks have to currently determine their investment strategy basis the limits available in their HTM book. The 2023 guidelines have now removed this limit, thereby providing banks an opportunity to determine their investment exposure to bonds without any classification consideration linked to limits. This would also be a big fillip to the primary bond market.

Reclassification of investments

- ***Alignment with Ind AS:*** The 2023 guidelines permit the reclassification of investments between different categories only in exceptional circumstances. This is similar to the principles of Ind AS, where reclassification between the different investment categories is permitted only in case of a change in the business model.
- ***Other benefits of restrictions on reclassification:*** The restrictions placed on reclassification of investments aim to drive efficient price discovery in the Government Security (G-Sec) market and imbibe effective market discipline on the G-Sec issuer. Additionally, prohibiting reclassification merely to ease the interest rate risks of banks would help to develop risk management systems with the concomitant benefit of giving depth to the market for interest rate hedging instruments.

Investment policy

There is no key change in the expectation on requirements and coverage of a bank's investment policy which is stipulated in the 2023 guidelines, as compared to the 2021 regulations. It is to be noted, that similar to the 2021 regulations, the 2023 guidelines would be applicable to subsidiaries and mutual funds established by banks except to the extent they are contrary to specific regulations.

B. Recognition and measurement

With regard to initial recognition and subsequent measurement of investments, the 2023 guidelines have prescribed the following:

Key requirements of the 2023 guidelines	Distinction from the 2021 regulations
Initial recognition and measurement - All investments should be measured at **fair value** on initial recognition[22] - Unless facts and circumstances suggest that the fair value is materially different from the acquisition cost, it must be presumed[23] that the acquisition cost is the fair value **Gain/loss on initial recognition** The 2023 guidelines have introduced the concept of a day 1 gain or loss. A day 1 gain or loss could arise on initial recognition of an investment, due to the difference between the fair value and the acquisition cost. Such a gain or loss would be accounted for differently, depending on whether the fair value is based on market observable inputs. *(Refer Annexure 2 for accounting of the day 1 gain/loss)*	As per the extant provisions, investments are initially recognised at acquisition cost.

Subsequent measurement

All investments are required to subsequently be measured as per the 2021 regulations for HTM, AFS or FVTPL. The specific measurement requirements in each of these categories is given below:

Key requirements of the 2023 guidelines	Distinction from the 2021 regulations
HTM investments - The securities held under HTM should be **carried at cost** and not be Marked to Market (MTM) after initial recognition - Any discount or premium on securities under HTM should be amortised over the remaining life of the instrument[24] - Investments under HTM would be subject to Income Recognition, Asset Classification and Provisioning (IRACP) norms	**HTM investments** The 2021 regulations have similar measurement requirements for HTM. Investments classified in HTM are required to be assessed for impairment, accordingly, there is no substantial change in this regard as compared to the 2023 guidelines.
AFS investments - The securities held under AFS should be **fair valued** at least on a quarterly basis, if not more frequently - The valuation gains and losses held under AFS (across all performing investments, irrespective of their classification) need to be aggregated and the net appreciation or depreciation should directly get credited or debited to a reserve named '**AFS reserve**[25]' without routing through the Profit and Loss Account - Any discount or premium on the acquisition of debt securities under AFS needs to be amortised over the remaining life of the instrument[24]	**AFS investments** Currently, while the requirement to fair value the AFS investments is the same, the treatment of the net appreciation and depreciation (of valuation gains) is different The net depreciation on AFS investments is currently required to be provided for (in the profit and loss account) and the net appreciation is to be ignored Profit or loss on sale of investments in the AFS category is required to be taken to the Profit and Loss Account.

[22] In respect of government securities acquired through auction, switch operations and Open Market Operations (OMO) conducted by the Reserve Bank of India (RBI), the price at which security is allotted should be the fair value for initial recognition purposes

[23] Situations wherein the presumption should be tested include where - the transaction is between related parties, the transaction is taking place under duress, where one party is forced to accept the price in the transaction, the transaction is done outside the principal market for that class of securities, other situations, wherein the opinion of supervisor, facts and circumstances warrant testing of the presumption.

[24] The amortised amount is required to be disclosed under item II 'Income on investments' of Schedule 13: 'Interest earned' with a corresponding disclosure in Schedule 8: 'Investments'

[25] The AFS reserve would be reckoned as Common Equity Tier (CET) 1 subject to certain conditions, and any unrealised gains transferred to AFS reserve would not be available for any distribution, such as dividend and coupon on Additional Tier 1

Key requirements of the 2023 guidelines	Distinction from the 2021 regulations
- Investments under AFS would be subject to IRACP norms - Upon sale or maturity of a **debt instrument** classified under AFS, the accumulated gain/loss in the AFS reserve should be transferred and recognised in the Profit and Loss Account[26]. However, in case of any **equity instrument** classified under AFS, any gain or loss on sale should be transferred to the capital reserve.	
FVTPL investments - The securities held under FVTPL must be **fair valued** and the net gain or loss arising on such valuation should be directly credited or debited to the Profit and Loss Account - Securities that are classified under the **HFT** sub-category within FVTPL should be fair valued on a daily basis, whereas **other securities** in FVTPL need to be fair valued at least on a quarterly basis, if not more frequently - Any discount or premium on the acquisition of debt securities under FVTPL should be amortised over the remaining life of the instrument[27] - Investments under FVTPL would be subject to the IRACP norms.	**HFT investments** Individual securities in the HFT category are required to be marked to market on a monthly basis or more frequent intervals (as per 2023 guidelines this is to be done on a daily basis for HFT and quarterly basis for other securities). The net depreciation on HFT investments is currently required to be provided for and the net appreciation is to be ignored.
Investments in subsidiaries, associates and joint ventures - All investments in subsidiaries, associates and joint ventures should be held at **acquisition cost** - Any discount or premium on the acquisition of debt securities of subsidiaries, associates and joint ventures must be amortised over the remaining life of the instrument[28] - The 2023 guidelines also stipulate the valuation of investments when an investee subsequently becomes a subsidiary, associate or a joint venture or when an investee ceases to be a subsidiary, associate or a joint venture - The gain/profit on reclassification/sale of an investment in a subsidiary, associate or joint venture should first be recognised in the Profit and Loss Account and then appropriated below the line to the Capital Reserve Account - Investments in subsidiaries, associates and joint ventures should be assessed for impairment at least on a quarterly basis. When there are indicators of impairment, banks should obtain an investment valuation certificate from an independent valuer. The provision for impairment should be provided and reversed through the Profit and Loss Account.	**Investments in subsidiaries, associates and joint ventures** The investment in subsidiaries, associates and joint ventures are currently classified under HTM. Accordingly, measurement regulations applicable to HTM investments would even apply here.

[26] This would be under item II 'Profit on sale of investments' under Schedule 14 'Other Income'

[27] The amortised amount needs to be disclosed in the financial statements under item II 'Income on investments' of Schedule 13: 'Interest earned' with a corresponding disclosure in Schedule 8: 'Investments'

[28] The amortised amount needs to be disclosed in the financial statements under item II 'Income on investments' of Schedule 13: 'Interest earned'

Key clarifications provided by the application guidance

Initial recognition

- **Fair value on initial recognition:** The transaction price on initial recognition would be presumed to be the fair value. In most situations[29], a comparison between the market transactions with the end-of-day price would not be required.
- **Clarification for special securities:** The fair value of special securities received from the Government of India towards recapitalisation of banks would be determined on the basis of the prices/yield to maturity of similar tenor Central Government securities put out by FBIL[30]. The difference between the acquisition cost and fair value so arrived would be immediately recognised in the Profit and Loss Account.
- **Fair value of equity shares acquired on satisfaction of a debt:** The fair value of such shares would be determined as below:
  - Where the shares are listed, its fair value would be the quoted price on NSE/BSE
  - Where the shares are unlisted, the fair value for would be the break-up value (without considering revaluation reserves).

Relevant other considerations

- Presently, investments are initially recognised at acquisition cost. However, in certain cases the acquisition cost may overvalue the investment, leading to distortion both in the value of the assets and equity as well as the regulatory capital of the reporting entities that invested in such instruments. Thus, the requirement introduced by RBI to undertake the initial recognition at fair value is a welcome step and is in line with Ind AS
- Section 15 of the Banking Regulations Act, 1949 precludes a bank from paying any dividend on its shares until all its capitalised expenses have been completely written off. Accordingly, in case of unquoted instruments (level 3 instruments), the day 1 loss is immediately recognised, while any gains have to be amortised upto the maturity of the instrument/held as a liability, as the case may be.

Our comments

Alignment with Ind AS

- ***Initial recognition:*** Ind AS 109 requires companies to initially recognise financial assets at fair value, and subsequently measure them at amortised cost, FVOCI or FVTPL. Accordingly, the initial recognition amendments in the 2023 guidelines are in line with Ind AS.
- ***HTM:*** As per Ind AS 109, the amortised cost of a financial asset is computed on the basis of the effective interest rate method. However, investments classified under HTM are measured at cost- thus the amendments in the measurement norms of the HTM investments are not completely aligned with Ind AS
- ***AFS and FVTPL:*** Investments classified in the FVOCI and FVTPL category should be fair valued on a periodical basis. The fair value gains and losses in case of FVOCI would be recognised in Other Comprehensive Income (OCI), whereas for FVTPL, the fair value gains and losses would be recognised in the statement of profit and loss. Additionally, the fair value gains or losses on equity instruments measured at FVOCI would not be transferred to profit or loss even on sale of such instruments.

  The 2023 guidelines have issued similar requirements for investments measured at AFS and FVTPL. Accordingly, the accounting for these instruments is largely aligned with Ind AS.

[29] Testing would be required in certain cases, such as transactions between related parties, coupons/ yield not in consonance with prevailing market yields, etc.
[30] Financial Benchmarks India Private Limited

C. Valuation

To increase the consistency and comparability in fair value measurements and related disclosures, the 2023 guidelines have prescribed the following:

<table>
<tr><th>Key requirements of the 2023 guidelines</th><th>Distinction from the 2021 regulations</th></tr>
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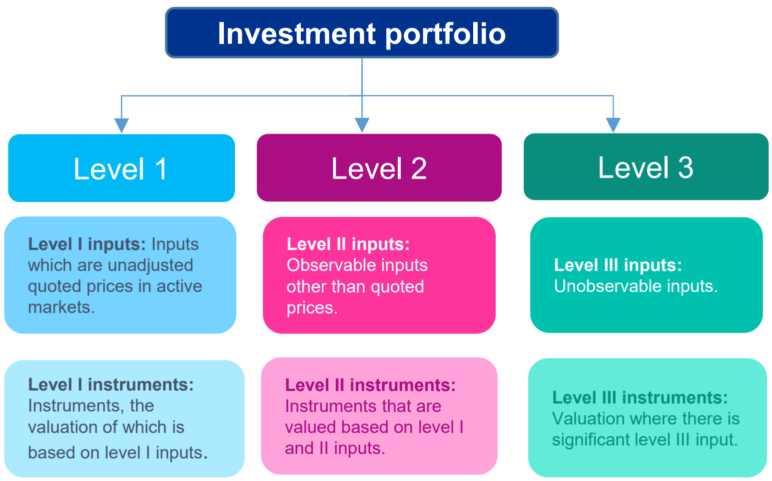
Fair value hierarchy

- As per the 2023 guidelines, an investment portfolio would be categorised into three fair value hierarchies, as below:



(Source: KPMG in India's analysis, 2023, read with the 2023 guidelines)

- Net unrealised gains recognised in the Profit and Loss account or in the AFS Reserve, which is arising on fair valuation of level 3 instruments would be deducted from CET 1 capital, and not be available for payment of dividend[31]
- The 2023 guidelines have prescribed a **format for disclosure** of the fair value hierarchy of the investment portfolio that is measured at fair value on the balance sheet. This disclosure would be applicable for financial year ending **31 March 2026**.

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The categorisation of the investment portfolio into level 1, level 2 and level 3 is a new requirement prescribed by the 2023 guidelines.
This is currently not there in the 2021 regulations.

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<tr><th>Key requirements of the 2023 guidelines</th><th>Distinction from the 2021 regulations</th></tr>
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Discontinuation of Investment Reserve Account (IRA)
The RBI has stipulated amendments in the 2023 guidelines, such as restricting dividend pay out from unrealised gains on fair valuation, exclusion of unrealised gain on fair valuation of level III investments from regulatory capital, etc.

Accordingly, an IRA is not required under the 2023 guidelines.

Investment Fluctuation Reserve (IFR)
The 2023 guidelines pertaining to IFR remain unchanged as compared to the 2021 regulations.

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Investment Reserve Account (IRA)
As per the 2021 regulations, the excess provision on account of depreciation of investments in the AFS or HFT categories is appropriated to IRA. This would be included as a part of the Tier II capital of the bank.

Investment Fluctuation Reserve (IFR)
The IFR is created by banks to address the systemic impact of sharp increase in yields in government securities.

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[31] An exception has been prescribed for the same in the 2023 guidelines

Key clarifications provided by the application guidance

Investments in securities: Investments in the following securities would be classified as under:

Security	Fair value hierarchy classification	Rationale for classification
Exchange Traded Fund (ETF)	Level 1	Since it is actively traded on a recognised stock exchange
Non-ETF open ended mutual fund	Level 1	Redemptions and subscriptions are taking place at the disclosed net asset value with sufficient volume to be considered as an active market
Units of AIF	Level 3	If such units are not actively traded, nor are there any subscriptions and redemptions at a daily published NAV

Our comments

- The disclosure of the valuation methods would ease certain regulatory concerns with regard to the valuation of securities which is not based on market inputs (for instance, in case of unquoted equity shares)

- ***Alignment with Ind AS***: With regard to the fair value hierarchy, Ind AS 113, *Fair Value Measurement*, also requires the disclosure of level 1, level 2 and level 3 instruments. Additionally, it *inter alia* also requires the disclosure of key assumptions used while valuing the level 3 instruments. Even though financial instruments measured at amortised cost are measured using the effective interest method, Ind AS 113 requires the disclosure of their fair value in the notes to the financial statements.

  The disclosure requirements in the 2023 guidelines are largely aligned with Ind AS, however, they are not as elaborate as in Ind AS 113.

  Banks are required to create an IFR, as it is a regulatory requirement, prescribed by RBI. It is to be noted that Ind AS being a principle-based standards, do not stipulate a similar requirement.

D. Transition and other amendments

Transition adjustments

The 2023 guidelines have prescribed the following treatment on transition to the 2023 guidelines (i.e., on 1 April 2024):

- **Reclassification of investment portfolio:** The investment portfolio as on 31 March 2024 would be reclassified as per the 2023 guidelines
  (Annexure 3 of this first note provides the specific treatment for transition from the previous to the revised framework)
- **Provision for depreciation:** The balance in the provision for depreciation of investments as on 31 March 2024 would be reversed into the Revenue/General Reserve
- **IRA:** The balance in IRA as on 31 March 2024 should be transferred to the Revenue/General Reserve or to IFR, depending on whether the bank meets the minimum IFR requirements
- **Disclosure requirements:** Suitable disclosures of transitional adjustments made should be disclosed in the notes to the financial statements for the year ending 31 March 2025**.**

Other amendments

Other amendments prescribed by the 2023 guidelines include:

Key requirements of the 2023 guidelines	Distinction from the 2021 regulations
Sale of investments from HTM - Sales from the HTM category should be made as per the policy approved by the **board of directors** of the bank - In any financial year, the carrying value of investments sold out of HTM should not exceed **five per cent**[32] of the opening carrying value of the HTM portfolio. Any sale beyond the aforementioned threshold would require prior approval of RBI - The 2023 guidelines have prescribed a **format for disclosure** of sales out of HTM, which require banks to disclose the **carrying value** of investments which are sold. This disclosure should be made in the notes to accounts of the financial statements - Any **profit or loss on the sale of investments** in HTM should be recognised in the Profit and Loss Account[33] and appropriated below the line to the Capital Reserve Account.	Currently, the 2021 regulations stipulate the following: - If the sales/transfers, to or from the HTM category exceeds five per cent of the book value of investments held in HTM at the beginning of the year, banks need to disclose **the market value of investments held in the HTM category** in the notes to accounts of the financial statements - Banks must also disclose the excess of book value over market value against which provision has not been made - The treatment of profit/loss on sale of investments from HTM is the same as the 2023 guidelines.

Key requirements of the 2023 guidelines	Distinction from the 2021 regulations
Accounting for derivatives - Banks should comply with the requirements of the **Guidance Note on Accounting for Derivative Contracts (revised 2021)** issued by the Institute of Chartered Accountants of India (ICAI), except for the current and non-current classification[34] - Derivative assets and liabilities would be presented as separate line items under: • *Schedule 11: Other Assets* • *Schedule 5: Other Liabilities*	The 2021 regulations do not provide a comprehensive guidance on the accounting of derivatives (especially hedge accounting). Thus the 2023 guidelines have newly introduced the accounting guidelines for derivatives

[32] Sale of securities in the following situations should be excluded from the regulatory limit of five per cent – Sales to RBI, such as the Open Market Operations (OMO) and GSAP, repurchase of government securities by Government of India from banks under buyback or switch operations, repurchase of state development loans by respective state governments under buyback or switch operations, repurchase, buyback or exercise of call option of non-SLR securities by the issuer, sale of non-SLR securities, following a downgrade in credit ratings or default by the counterparty, sale of securities as part of a resolution plan under the Prudential Framework for Resolution of Stressed Assets for a borrower facing financial distress, etc.
[33] The profit or loss on sale should be recognised under Item II of Schedule 14: 'Other Income'.
[34] This is because, the balance sheet of banks prepared as per the Third Schedule to the Banking Regulation Act, 1949 do not provide for any distinction between current and non-current.

- The derivative portfolio is required to be categorised into three fair value hierarchies- viz. Level 1, Level 2 and Level 3. The disclosure of the same is required to be made in the notes to accounts - Dividends will not be paid out of net unrealised gains recognised in the Profit and Loss Account arising on fair valuation of Level 3 derivative assets and liabilities. Such unrealised gains are to be deducted from CET 1 capital.	

Key clarifications provided by the application guidance

Repo transactions: Repo of securities from the HTM category, which are compliant with the relevant directions[35], would not be considered as sale from HTM.

E. Disclosures

Disclosures are intended to facilitate an evaluation of the significance of the financial instruments in the entity's financial position and performance as well as of the risks emanating therefrom. The 2023 regulations have enhanced the disclosure requirements pertaining to investments held by banks. Some of the key disclosures required to be provided in the notes to accounts in the financial statements include the following:

<table>
<tr><th>Key requirements of the 2023 guidelines</th><th>Distinction from the 2021 regulations</th></tr>
<tr><td>
Disclosures in the notes to accounts

The 2023 guidelines have prescribed the following disclosures that are required to be made in the notes to accounts of the banks. Their applicability date has also been prescribed as under. It is to be noted, that all these disclosures also require comparative amounts to be provided as well. The formats of these disclosures are a part of Annex II of the 2023 guidelines.
<table>
<tr><th>Disclosure</th><th>Effective date</th></tr>
<tr><td>Carrying amounts and fair value
Carrying amounts and fair value of each of the categories (i.e., HTM, AFS, FVTPL) and each class (i.e., government securities, other approved securities, shares, debentures and bonds, subsidiaries, associates and joint ventures, others). These disclosures also require the categorisation and class of investments made outside India.</td><td>Disclosure in notes to accounts of financial statements for the year ending 31 March 2025</td></tr>
<tr><td>Gain/loss on investments
This would require disclosure of gain/loss for each category of investments that has been recognised in the Profit and Loss Account or in the AFS Reserve</td><td>Disclosure in notes to accounts of financial statements for the year ending 31 March 2025</td></tr>
<tr><td>Disclosures as per fair value hierarchy
For each class of investment, banks would need to disclose the investments that are subsequently measured at AFS and FVTPL- and break these amounts up, basis the fair value hierarchy</td><td>Disclosure in notes to accounts of financial statements for the year ending 31 March 2026</td></tr>
</table>
</td><td>The disclosure requirements in the 2023 guidelines are new, and similar requirements are currently not prescribed by the 2021 regulations</td></tr>
</table>

[35] Repurchase Transactions (Repo) (Reserve Bank) Directions, 2018

Disclosure	Effective date
Disclosure of sales made out of HTM This disclosure includes the opening carrying value of investments in HTM, carrying value of investments sold (which excludes the carrying value of investments sold that are exempted from the regulatory limits), and the amount transferred to capital reserve in respect of HTM securities sold at a gain	Disclosure in notes to accounts of financial statements for the year ending 31 March 2025
Details of derivative portfolio This requires the disclosure of MTM of the assets and liabilities of the interest rate derivatives, exchange rate derivatives, credit risk derivatives and other derivatives, and their break up in the fair value hierarchy	Disclosure in notes to accounts of financial statements for the year ending 31 March 2025[36]
Transition related adjustments	Disclosure in notes to accounts of financial statements for the year ending 31 March 2025

Our comments

- ***Disclosures:*** The 2023 guidelines have prescribed robust disclosures pertaining to the investment portfolio of a bank. Most of these disclosures are required to be made in the financial statements for the year ending 31 March 2025. Banks should put in appropriate systems and processes to gather this information. Certain disclosures require banks to report the profit and loss impact of a transaction or publish the opening balance of investments in an investment category for a particular financial year as well as for the comparative period. Currently, banks do not have such information for FY2023-24. Accordingly, further clarification is required from RBI on whether banks would be required to report on comparatives in the financial statements for the year ending 31 March 2025 or an exemption may be provided for the first year.

- ***Disclosure of derivative portfolio:*** The 2023 guidelines require banks to disclose the categorisation of their investment portfolio which is measured at fair value in the three fair value hierarchies, i.e. Level 1, Level 2 and Level 3 depending on the inputs used to compute the fair value. This disclosure is applicable for financial statements for the year ending 31 March 2026 and onwards. Even the derivative portfolio of banks needs to be categorised in the fair value hierarchy. However, it is unclear whether the disclosure of the derivative portfolio would be applicable for financial statements for the year ending 31 March 2025 or for the year ending 31 March 2026, along with the disclosure of the fair value hierarchy of the investment portfolio. Further clarification would be required on this aspect.

- ***Alignment of the 2023 guidelines with Ind AS:*** Currently, banks are required to prepare their books of accounts in accordance with the accounting standards (IGAAP) along with the regulatory norms issued by RBI, and the adoption of Ind AS has indefinitely been deferred. However, considering that global banks follow international standards on accounting (e.g., IFRS, US GAAP), RBI is gradually making the transitional shift to an international financial reporting framework. Recently, RBI had issued a discussion paper on implementing ECL based impairment for banks which adopted some principles on impairment prescribed in Ind AS 109 (IFRS 9, *Financial Instruments*). The issuance of the 2023 guidelines would require banks to classify and measure their investments in accordance with the new regulations which are closely aligned with Ind AS 109 (IFRS 9). This is a big step towards universal comparability of banks' financial statements at least with regard to its investment portfolio prior to the full adoption of Ind AS by banks in India.

[36] Given that disclosures of the derivative portfolio includes bifurcation of the fair value in level 1, 2 and 3, and the disclosures pertaining to the fair value hierarchy are applicable from FY2025-26, further clarification is required on the applicability date for disclosures of derivatives

Annexure 1: Accounting treatment in case of reclassifications between categories

The table below specifies the accounting treatment to be followed by banks, while undertaking reclassification of investments from one category to another:

<table>
<tr><th>Reclassification from</th><th>Reclassification to</th><th>Accounting treatment</th></tr>
<tr><td rowspan="2">HTM</td><td>AFS</td><td>The fair value measured at the reclassification date should be the revised carrying value

Any gain or loss arising from a difference between the revised carrying value and the previous carrying value to be recognised in AFS-Reserve</td></tr>
<tr><td>FVTPL</td><td>The fair value measured at the reclassification date should be the revised carrying value

Any gain or loss arising from a difference between the revised carrying value and previous carrying value to be recognised in the Profit and Loss Account under Item (III): ‘Profit on revaluation of investments’ under Schedule 14: ‘Other Income’</td></tr>
<tr><td rowspan="2">AFS</td><td>HTM</td><td>The investments are reclassified at its fair value at the reclassification date. However, to arrive at the revised carrying value, the cumulative gain/loss previously recognised in the AFS-Reserve should be withdrawn and adjusted against the fair value of investments at the reclassification date.

Thus, the revised carrying value should be the same, as if bank had classified the investment in HTM itself</td></tr>
<tr><td>FVTPL</td><td>The investments would continue to be measured at fair value.

The cumulative gain or loss previously recognised in AFS Reserve should be withdrawn and recognised in the Profit and Loss Account, under Item (III): ‘Profit on revaluation of investments’ under Schedule 14: ’Other Income’</td></tr>
<tr><td rowspan="2">FVTPL</td><td>HTM</td><td rowspan="2">The carrying amount representing the fair value at reclassification date remains unchanged.</td></tr>
<tr><td>AFS</td></tr>
</table>

Annexure 2: Accounting for day 1 gain/loss on initial recognition of investments

The day 1 gain/loss would be accounted for as below:

Investment	**Accounting for**	
	Day 1 gain	**Day 1 loss**
Level 1/Level 2 instruments[37]	Recognised in profit and loss account, under Schedule 14- 'Other Income' within the subhead 'Profit on revaluation of investments' or 'Loss on revaluation of investments' as the case may be	
Level 3 instruments- debt instruments	Amortised on a straight-line basis up to the maturity date	Recognised immediately
Level 3 instruments- unquoted equity instruments	Set aside as a liability until the security is listed or derecognised	Recognised immediately

[37] Securities which are quoted or whose fair value can be determined based on market observable inputs

Annexure 3: Specific treatment of investments on transition from 2021 regulations to the 2023 guidelines

Previous framework	Revised framework	Opening accounting adjustments on 1 April 2024
HTM[38]	HTM	The acquisition cost adjusted for any premium/ discount amortised between date of acquisition and 31 March 2024, would be the revised carrying value. The difference between the revised carrying value and the previous carrying value should be adjusted in any revenue/general reserve
	AFS	The fair value as at 31 March 2024 should be the revised carrying value. The difference between the revised carrying value and previous carrying value should be adjusted in AFS reserve
	FVTPL	The fair value as at 31 March 2024 should be the revised carrying value. The difference between the revised carrying value and previous carrying value to be adjusted in any revenue/general reserves
AFS	HTM	The acquisition cost adjusted for any premium/ discount amortised between the date of acquisition and 31 March 2024 should be the revised carrying value. The difference between the revised carrying value and previous carrying value to be adjusted in revenue/general reserve
	AFS	The fair value of the investment as at 31 March 2024 would be the revised carrying value. The difference between the revised carrying value and previous carrying value to be adjusted in AFS reserve
	FVTPL	The fair value as at 31 March 2024 should be the revised carrying value. The difference between the revised carrying value and previous carrying value to be adjusted in any revenue/general reserves
HFT	HTM	The acquisition cost adjusted for any premium/discount amortised between date of acquisition and 31 March 2024 should be the revised carrying value. The difference between the revised carrying value and previous carrying value to be adjusted in revenue/general reserve
	AFS	The fair value as at 31 March 2024 should be the revised carrying value. The difference between the revised carrying value and previous carrying value to be adjusted in AFS reserve
	FVTPL	The fair value as at 31 March 2024 should be the revised carrying value. The difference between the revised carrying value and previous carrying value to be adjusted in any revenue/general reserves

[38] In respect of special securities received from the Government of India towards bank recapitalisation, the acquisition cost would be as determined at initial recognition in terms of the principles specified in the Master Directions 2023

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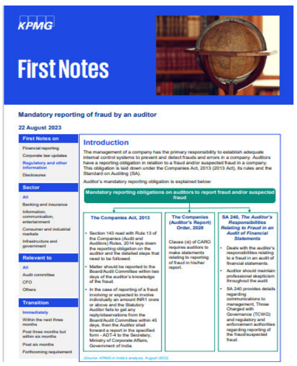
Missed an issue of Accounting and Auditing Update or First Notes?

Issue no. 86 – September 2023

The topics covered in this issue are:

- Enhanced requirements proposed for going concern assessment
- ESG investing by mutual funds
- Regulatory updates

To access the publication, please click here



Mandatory reporting of fraud by an auditor

22 August 2023

The management of a company has the primary responsibility to establish adequate internal control systems to prevent and detect frauds and errors in a company. Auditors have a reporting obligation in relation to a fraud and/or suspected fraud in a company. This obligation is laid down under the Companies Act, 2013, its Rules and the Standard on Auditing.

On 26 June 2023, the National Financial Reporting Authority (NFRA) issued a circular (the Circular) to clarify the responsibility of statutory auditors in relation to reporting of fraud in a company. Some important clarifications from the circular are as follows:

- Mandatory obligation to report fraud by an auditor
- Procedure to report fraud by an auditor
- Auditor not being the first person to identify the fraud
- Resignation by an auditor
- Professional skepticism

To access the First Note, please click here

KPMG in India is pleased to present Voices on Reporting – Quarterly updates publication June 2023

Voices on Reporting – Quarterly updates publication (for the quarter ended 30 June 2023) provides a summary of key updates from the Securities and Exchange Board of India (SEBI), the Ministry of Corporate Affairs (MCA), the Reserve Bank of India (RBI), the National Financial Reporting Authority (NFRA) and the Institute of Chartered Accountants of India (ICAI).

To access the publication, please click here

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