Annex V

Illustrative Guidance on application of the Reserve Bank of India (Classification, Valuation and Operation of Investment Portfolio of Commercial Banks) Directions, 2023

Chapter – III Classification of Investments by Banks

Q. No. 1: Whether similar securities can be classified under different categories (viz. HTM, AFS or HFT) - for example, with respect to a debt security fulfilling the Solely Payment of Principal and Interest (SPPI) criteria, whether the quantity/lot acquired at one point in time can be classified in the HTM category while another lot acquired subsequently is classified under different category?

(Refer Clause 6 of Directions)

Ans: A bank may have different objectives with which it invests in securities. For instance, a bank may hold a portfolio of debt securities that it manages in order to collect contractual cash flows and another portfolio of similar debt securities that it acquired with the purpose of trading (HFT) or for liquidity purposes (AFS). Therefore, similar 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. However, the objective with which the securities are being acquired should be clearly established and documented before or at the time of acquisition.

Q. No. 2: In which category would securities acquired/ held for SLR purposes be classified?

(Refer Clause 6 of Directions)

Ans: The classification principles outlined in the Reserve Bank of India (Classification, Valuation and Operation of Investment Portfolio of Commercial Banks) Directions, 2023, are not based on criteria used for differentiating between the SLR and non-SLR securities. Accounting classification is based on the objective with which the security was acquired and the SPPI criterion. Therefore, SLR and non-SLR securities that meet SPPI criteria can be classified under HTM, AFS or HFT depending upon the objective with which they have been acquired. Securities that do not meet SPPI criteria would need to be classified under FVTPL (including under HFT sub-category if acquired for trading).

Q.No. 3: Whether the SLR securities used for purposes such as liquidity or interest rate risk management can qualify for HTM category?

(Refer Clause 6.2 of Directions)

Ans: The bank would need to determine whether the objective with which it acquires a security would allow it to hold the security to maturity (HTM) or whether it would require flexibility to routinely sell those securities before maturity (AFS). Illustratively, if the objective with which a security is acquired is to manage everyday liquidity needs, the bank would need the flexibility 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 need not necessarily be classified under AFS, if the bank does not intend to routinely sell the security before maturity and instead intends to liquidate such an investment before maturity only when facing a liquidity stress.

Q.No. 4: As per extant norms banks are required to maintain LCR', which *inter-alia* requires the maintenance of adequate level of HQLA that can be converted into cash to meet liquidity needs for a 30 calendar day horizon. The extant regulations require that HQLA should be free of any encumbrance (legal, regulatory or operational) and capable of being readily sold or used as collateral to obtain funds in a range of stress scenarios. One of the key regulatory requirements is that banks should periodically monetize a proportion of assets through repo or outright sale to test the saleability of these assets and to minimize the risk of negative signalling during period of stress. Whether securities held to comply with LCR qualify for classification under HTM?

(Refer Clause 6.1(a)(i) of Directions)

Ans: It may be noted that the regulatory objective of periodic monetisation of assets can also be met through repo. Repo of securities shall not be inconsistent with the

HTM classification. On the other hand, if the bank intends to sell securities to meet the regulatory objective and the value of the securities to be sold is significant (i.e. more than five per cent of the opening carrying value of the HTM portfolio), such securities would not meet the criteria to be categorised under HTM.

Q.4A Can investments in bonds with a put option be classified under the HTM category?

(Refer Chapter III to the Directions)

Ans:

a. For a security to be classified under HTM category, contractual terms of the security should give rise to cash flows that meets the SPPI criterion and the security must be acquired with the intention and objective of holding it to maturity. Accordingly, the bond with put option meeting these criteria can be classified under HTM.

b. Exercise of put option, prior to maturity, is generally not consistent with the intention and objective of holding to maturity and, therefore, may be treated as sale out of HTM. However, if the put option is exercised in scenarios such as a downgrade in credit ratings or default by the counterparty, the intention and objective of holding to maturity may not be considered as vitiated.

Q.No.5: What are the general aspects that can be considered for SPPI criterion?

(Refer Clauses 6.1(a)(ii), 6.1(b),6.2(a)(ii) and 6.3(a) of Directions)

Certain general aspects with respect to the solely payment of principal and interest ('SPPI') criteria are as under:

(i) Securities with contractual cash flows that meet 'SPPI criterion' are consistent with a **'basic lending arrangement'**. In a basic lending arrangement, time value of money and credit risk are the most significant elements of the interest component. However, interest could also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time as well as a profit margin.

(ii) Contractual terms that introduce exposure to risk or volatility in contractual cash flows that is unrelated with a basic lending arrangement, such as exposure to change in equity price or commodity price, do not give rise to contractual cash flow that are consistent with the SPPI criterion.

(iii) In respect of foreign currency denominated securities, banks shall assess whether contractual cash flows meet SPPI criterion for the currency in which the investment is denominated rather than making such determination after translating to Indian Rupee.

Securities that meet the SPPI criteria would *inter-alia* include debt instruments with a specified maturity/call date such as Government Securities (including non-interest-bearing recapitalisation bonds) and non-convertible Corporate Bonds, perpetual instruments (without contractual loss absorbency features such as discretionary coupons/ dividends and contingent write-off/ conversion to equity).

Q.No. 6: In cases where the interest rates are regulated, would interest charged meet the criteria of time value of money for evaluating SPPI criterion?

(Refer Clauses 6.1(a)(ii), 6.1(b), 6.2(a)(ii) and 6.3(a) of Directions)

Ans: Regulated interest rate shall be considered as a proxy for the time value of money element for the purpose of assessing SPPI criterion.

Q.No. 7: As part of Basel III Capital Regulations in India, banks are permitted to include Perpetual Non-Cumulative Preference Shares (PNCPS) and Perpetual Debt Instruments (PDI) issued by them subject to certain conditions as part of Additional Tier 1 (AT1) capital. These conditions *inter-alia* include loss absorption features that entail a write down/ conversion to equity at certain pre-specified triggers. In order to be eligible for inclusion in AT 1 these features have to be contractually included. Similarly, with respect to debt instruments qualifying for Tier 2 capital under Basel III, certain loss absorbency features such as Point of Non-Viability (PONV) trigger are required to be contractually

included. The issue arises as to whether investments in such AT1 and Tier 2 instruments would be eligible for HTM or AFS classification?

(Refer Clauses 6.1(a)(ii), 6.1(b), 6.2(a)(ii) and 6.3(a) of Directions)

Ans. The contractual cash flows would not meet SPPI criterion if the contractual terms of the securities permit or require the issuer (or another entity) to impose losses on the holder (for example, by writing down the par value or by converting the instrument into a fixed number of the issuer's ordinary shares). They would not meet SPPI even if the probability is remote that such a loss will be imposed. Thus, Basel III compliant AT 1 and Tier 2 instruments would not meet SPPI criterion and cannot be classified under HTM or AFS.

Q.No.8: Whether inflation indexed bonds meet the SPPI criterion. The inflation indexed bonds have stated maturity date and payments of principal and interest on the principal amount outstanding are linked to an inflation index of the currency in which the instrument is issued. The inflation link is not leveraged, and the principal is protected.

(Refer Clauses 6.1(a)(ii), 6.1(b), 6.2(a)(ii) and 6.3(a) of Directions)

Ans: Linking payments of principal and interest on the principal amount outstanding to an unleveraged[44] inflation index resets the time value of money to a current level. In other words, the interest rate on the instrument reflects 'real' interest. Thus, the interest amounts are consideration for the time value of money on the principal amount outstanding. Therefore, the contractual cash flows could be considered to meet SPPI criterion.

[44] Leverage is a contractual cash flow characteristic of some financial instruments. In the general sense a leveraged financial product allows an investor to take exposure higher than his investment into that product. In this specific context, it refers to a payment that is a multiple of the index. It may be noted that leveraged financial products including derivatives would not meet the SPPI criteria.

Q.No. 9: Whether securities with step-up and step-down interest rate features meet SPPI criterion?

(Refer Clauses 6.1(a)(ii), 6.1(b), 6.2(a)(ii) and 6.3(a) of Directions)

Ans. Securities with step-up and step-down interest rate shall meet 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 a profit margin. If interest rate changes based on certain event, banks need to assess the nature of any contingent event (i.e., the trigger) that would change the timing or amount of the contractual cash flows. For example, 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.

Q.No. 10: Do subordinated securities meet SPPI criterion?

(Refer Clauses 6.1(a)(ii), 6.1(b), 6.2(a)(ii) and 6.3(a) of Directions)

Ans. A security that is subordinated to other securities may have contractual cash flows that meet SPPI criterion if the debtor's non-payment is a breach of contract, and the holder has a contractual right to unpaid amounts of principal and interest on the principal amount outstanding even in the event of the debtor's bankruptcy, albeit after all the senior creditors are first paid-off. In general, subordinated bonds/debentures carry higher interest rates - such higher rates may generally be attributable to the additional credit risk borne by the holders. Therefore, such bonds may not necessarily fail the SPPI criteria.

Q.No. 11: Whether a security that pays an inverse floating interest rate (i.e., the interest rate has an inverse relationship to market interest rates) meet SPPI criterion?

(Refer Clauses 6.1(a)(ii), 6.1(b), 6.2(a)(ii) and 6.3(a) of Directions)

Ans. The contractual cash flows of such securities shall not meet SPPI criterion. The interest amounts are not consideration for the time value of money on the principal amount outstanding.

Q.No.12: A security is a perpetual instrument, but the issuer may call the instrument at any point and pay the holder the par amount plus accrued interest due. This security pays a market interest rate, but payment of interest cannot be made unless the issuer is able to remain solvent immediately afterwards. Deferred interest does not accrue additional interest. Would this security be considered as meeting the SPPI criterion?

(Refer Clauses 6.1(a)(ii), 6.1(b), 6.2(a)(ii) and 6.3(a) of Directions)

Ans. The fact that security is perpetual does not in itself mean that the contractual cash flows do not meet SPPI criterion. In effect, a perpetual instrument has continuous (multiple) extension options. Such options may result in contractual cash flows that meet SPPI criterion if interest payments are mandatory and must be paid in perpetuity. Also, the fact that security is callable does not mean that the contractual cash flows do not meet SPPI criterion unless it is callable at an amount that does not substantially reflect payment of outstanding principal and interest on that principal amount outstanding. Even if the callable amount includes an amount that reasonably compensates the holder for the early termination of the instrument, the contractual cash flows could meet SPPI criterion.

In the given case, the contractual terms provide for deferment of interest wherein additional interest does not accrue. Consequently, interest amounts are not consideration for the time value of money on the principal amount outstanding. Therefore, contractual cash flows do not meet SPPI criterion.

Q.No. 13: Will investment in units of investment funds (like mutual funds, AIFs, etc.) meet SPPI criterion?

(Refer Clauses 6.1(a)(ii), 6.1(b), 6.2(a)(ii) and 6.3(a) of Directions)

Ans. Contractual cash flow in case of investment funds (like mutual fund) is mostly through redemption of units or dividends on such units. This may include fair value change of underlying assets in which the fund has invested. Therefore, the contractual cash flow from units of investment funds such as Mutual Funds, Alternative Investment Funds, etc. generally do not meet the SPPI criterion. No look through approach is envisaged in such cases.

Q.No.14: Whether investment in Security Receipts (SR) / Pass Through Certificates (PTCs)/ other securities issued by Asset Reconstruction Companies predicated on recovery from underlying securities meet SPPI criterion?

(Refer Clauses 6.1(a)(ii), 6.1(b), 6.2(a)(ii) and 6.3(a) of Directions)

Ans. The contractual cash flow in SR, PTC or other securities issued by ARCs predicated on recoveries from the underlying asset may not strictly represent payment of principal and interest on the principal amount outstanding. Therefore, such investments shall not meet the SPPI criterion.

Q.No.15: A bank has invested in a financial asset with an embedded derivative. Should the asset be tested for SPPI criterion separately and the embedded derivative accounted for separately?

(Refer Clauses 6.1(a)(ii), 6.1(b), 6.2(a)(ii) and 6.3(a) of Directions)

Ans. Where a bank has invested in a hybrid financial asset with an embedded derivative, it should test the instrument in its entirety for SPPI criterion and classify accordingly rather than separating the embedded derivative from the instrument.

Q.No.16: Whether securities otherwise fulfilling the criteria for HTM classification but hedged with an Interest Rate Swap (IRS) as under be continued to be classified under HTM?

(a) Can a floating rate note swapped to fixed yield using IRS be held under HTM?

(b) Can a fixed rate bond where a fixed to floating swap has been entered into be kept under HTM?

(Refer Clauses 6.1(a)(ii), 6.1(b), 6.2(a)(ii) and 6.3(a) of Directions)

Ans. In both cases, the derivative is a separate transaction from the hedged item. The hedged item will be classified as per the requirements of the directions. Therefore, if the bank intends to hold the instrument to maturity and the instrument meets the SPPI criterion, it can be classified under HTM. The derivative on the other hand, shall be accounted for as per the ICAI's Guidance Note on Accounting for Derivative Contracts. Subject to the bank complying with the hedge accounting requirements of the said Guidance note, it may make changes in the carrying value of the hedged instruments as specified in the said Guidance Note.

Q.No.17: In the case of an investment in a securitisation tranche, how will a bank determine if the credit risk of the tranche is equal to or lower than the credit risk of the combined underlying pool of assets?

(Refer Clauses 6.1(a)(ii), 6.1(b), 6.2(a)(ii) and 6.3(a) of Directions)

Ans. In some cases, it might be possible to compare the credit rating allocated to the tranche as compared with that (or the average of those) for the underlying pool of financial instruments, if they are all rated. Also, for the more senior and junior tranches, it may be obvious, with relatively little analysis, whether the tranche is less or more risky than the underlying assets. However, in some circumstances involving complex securitisation structures, a detailed assessment may be required. Where such an assessment cannot be made easily, the investment in the tranche shall be treated as not meeting the SPPI criterion.

Chapter – IV Initial recognition

Q.No.18: What is the fair value of a security at initial recognition? Do we need to compare the transaction price with the end-of-day price?

(Refer Clause 7 of Directions)

Ans. The transaction price at initial recognition shall be presumed to be the fair value. Generally, this presumption need not even be tested especially in an arms' length transaction between unrelated parties in an active market. Where securities are acquired through an auction such as a corporate bond being acquired through bidding on an electronic bidding platform (EBP) on a recognised stock exchange and in compliance with extant SEBI regulations, the presumption that the bid price is the fair value generally holds. Accordingly, there is no need to compare market transactions with the end-of-day price in most situations. However, in certain situations such as transactions between related parties, coupons/ yield not in consonance with prevailing market yields, etc. this presumption needs to be tested.

Q.No.18A: How should the fair value of investments at initial recognition be determined?

(Refer Clauses 7 and 23 of Directions)

Ans. In terms of clause 7 of the Directions, all investments shall be measured at fair value on initial recognition. Unless facts and circumstances suggest that the fair value of investments is materially different from its acquisition cost, it shall be presumed that at initial recognition, the acquisition cost is the fair value. In cases where this presumption does not hold, the fair value of investments at initial recognition shall be determined in terms of Chapter VIII of the Directions.

Q.No.19: At what value will special securities received from Government of India towards a bank's recapitalisation requirement be recognised and how should they be fair valued for disclosure purpose?

(Refer Clause 7 of Directions)

Ans. Special securities received from the Government of India towards recapitalisation of banks shall be initially recognised at their fair value based on the prices/YTM put out by FBIL or as determined under the clause 26.1(c) of these Directions, as the case may be. Any difference between the acquisition cost and fair value so arrived shall be immediately recognized in the Profit and Loss Account. Further, subsequent valuation of such special securities, for disclosure purpose, shall be based on the clause 26.1(c) of these Directions.

Q.No.20: An equity share which is acquired in satisfaction of a debt is listed and actively traded on the National Stock Exchange (NSE) and BSE. How should it be recognised? What if the share is not listed?

(Refer Clauses 7 and 26.3 of Directions)

Ans. As the transaction has taken place outside the principal market for the equity shares it should be recognised at its fair value. The fair value shall be determined in terms of Chapter VIII of these Directions. Thus, where the share is listed its fair value shall be the quoted price on NSE/ BSE. Where the share is unlisted, the fair value for the purpose of these Directions shall be the break-up value.

Chapter – V Subsequent Measurement

Q.No.20A: What is the period over which the discount or premium should be amortised for securities with a call or put option?

(Refer Chapter V of Directions)

Ans. The discount/premium on securities, including on securities with the call/put option, shall be amortised over its residual contractual maturity. Further, the discount/premium on perpetual debt security shall be amortised up to the earliest call date.

Chapter – VI Reclassifications between categories

Q.No.21: When is the reclassification recorded in the books of the bank?

(Refer Chapter-VI of Directions)

Ans. If a bank is permitted to reclassify its investment portfolio, it shall apply the reclassification prospectively from the reclassification date. The entity shall not restate any previously recognised gains, losses or interest. The reclassification date shall be the first day of the first reporting period following the supervisory permission allowing reclassification of financial asset. For example, an entity with a reporting year-end of 31st 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.

Chapter – VII Sale of investments from HTM

Q.No.22: Will securities sold under repo from HTM category considered as sale from HTM?

(Refer Chapter-VII of Directions)

Ans. In terms of Annex I to Repurchase Transactions (Repo) (Reserve Bank) Directions, 2018, repo transactions are accounted for as a collateralised lending and borrowing transaction with an agreement to repurchase, on the agreed terms.

Therefore, repo of securities from HTM category, compliant with the said directions, shall not be considered as sale from HTM.

Chapter -VIII- Fair Value of Investments

Q.No.23: Under which level of the fair value hierarchy would investments in units of a mutual fund be categorised?

(Refer Clause 27 of Directions)

Ans. The regulatory intent behind requiring the disclosure of fair value hierarchy is to indicate the level of reliability of the fair value measurement. Therefore, where the investment is in an Exchange Traded Fund (ETF) which is actively traded on a recognised stock exchange, the fair valuation of such units based on unadjusted quoted prices of the ETF shall be categorised as Level 1. In the case of non-ETF open ended Mutual Funds, where redemptions and subscriptions are taking place at the disclosed Net Asset Value on a daily basis with sufficient volume to be considered an active market, the investment may be classified as Level 1.

Q.No.24: Under which level of the fair value hierarchy would investments in units of an Alternative Investment Fund (AIF) be categorised?

(Refer Clause 27 of Directions)

Ans. If the units of the AIF are not actively traded nor are there any subscriptions and redemptions at a daily published NAV, the valuation shall be classified as Level 3.

Chapter X - *Income Recognition, Asset Classification and Provisioning*

Q.No.24A: Clause 36(a)(v) of the Directions prescribe that in case of conversion of principal and/or interest into equity shares, debentures, bonds, etc., such instruments shall be classified in the same asset classification category as the loan and provision shall be made as per the norms. Further, if post conversion, the classification is standard or subsequently upgraded to standard as per the IRACP norms, the investment shall be categorised in HTM, AFS or FVTPL (including HFT) as per the requirements of Chapter III. Does this imply that the

banks shall be allowed to classify these securities under HTM, AFS, or FVTPL (including HFT) only upon upgradation and not at initial recognition? Also, clarity is required on the what is meant by the segregation of such NPI investments from the rest of the portfolio?

(Refer Clauses 36(a)(v) & 36(b)of Directions)

Ans:

In partial modification to the clause 36(a)(v), it is clarified that the equity shares, debentures, bonds, etc., received upon conversion of principal and/or interest shall, be classified under HTM, AFS, or FVTPL (including HFT) only at initial recognition (i.e., when the loan is derecognised and the bond/equity, etc. is recognised), as per Chapter III of the Directions. Banks may, however, note that the asset classification of such instruments shall be the same as the loan and provisions made accordingly as stated in clause 36(a)(v).

The clause 36(b) of the Directions prescribes that once an investment becomes NPI, it should be segregated from rest of the portfolio and not considered for netting valuation gains and losses. It is clarified that the ‘segregation from the rest of the portfolio’ in this context means that such investments shall be segregated from other investments within the same category [i.e., HTM, AFS, or FVTPL (including HFT)] under which it was classified at initial recognition. Reclassification of the securities shall be guided by provisions of Chapter VI of the Master Direction.

Chapter XIV - *Transition and Repeal Provisions*

Q.No.24B: Should special securities[44B] received from the Government of India towards the bank’s recapitalisation requirement before FY 2021-22 be recognised at fair value at the time of transition to revised guidelines?

[44B] Special securities mean non-interest bearing (non-transferable) special GoI securities issued at par.

(Refer Clause 43 of Directions)

Ans: As per the clause 43 of the Directions, at the time of transition, the revised carrying value of securities classified under the HTM category shall be its acquisition cost adjusted for any premium/ discount amortised between the date of acquisition and March 31, 2024. Further, footnote number 35 to this clause specifies that in respect of special securities received from the Government of India towards the bank's recapitalisation, the acquisition cost shall be as determined at initial recognition in terms of Chapter IV of this Directions. Accordingly, at the time of transition, as per Chapter IV of the Directions, the acquisition cost of these securities shall be the fair value at initial recognition arrived based on the prices / YTM of similar tenor Central Government securities put out by FBIL. Therefore, the revised carrying value of such special securities shall be fair value at initial recognition adjusted for any premium/ discount amortised between the date of acquisition and March 31, 2024. Further, as given in the clause 43 of the Directions, the difference between the revised carrying value and the previous carrying value shall be adjusted in any General /Revenue Reserves.

Q.No.24C: Whether net unrealised gain on Level 3 instruments transferred to General/Revenue Reserves or in AFS-Reserves at the time of transition should be deducted from CET 1 capital?

(Refer Clauses 28, 41 and 43 of Directions)

Ans: Net unrealised gain on Level 3 instruments (including investments and derivatives) transferred to Revenue/ General Reserve and AFS-Reserve at the time of transition, i.e., April 1, 2024, should be deducted from CET 1 capital.

Q.No.24D: At the time of transition, how would the revised carrying value of securities held under HTM, AFS and HFT in the previous framework and re-classified to HTM in the revised framework be calculated?

[Refer Clause 43 of Directions]

Ans: The clause 43 of the Directions prescribes that, at the time of transition, the revised carrying value of securities to be classified under HTM shall be the acquisition cost adjusted for any premium/ discount amortized between the date of acquisition and March 31, 2024. Only in exceptional circumstances, where it is not practicable for banks to calculate revised carrying value as above, the fair value of the securities as of March 31, 2024, may be taken as the revised carrying value.

Further, as given under the clause 43, the difference between the revised carrying value and the previous carrying value, shall be adjusted in any General/Revenue Reserves.

Q.No.24E: At the time of transition, how would the revised carrying value of securities held under HTM, AFS and HFT in the previous framework and re-classified to AFS in the revised framework be calculated?

[Refer Clause 43 of Directions]

Ans: The clause 43 of the Directions prescribes that, at the time of transition, the revised carrying value of securities to be classified under AFS shall be fair value as at March 31, 2024, and the difference between the revised and the previous carrying value shall be adjusted in AFS-Reserve.

In view of the response to Q.No. 24(d) above, in modification to the above clause, it is now advised that the difference between the revised and the previous carrying value shall be adjusted in Revenue/General Reserve rather than AFS-Reserve. However, in the case of equity instruments designated under AFS difference between the revised and the previous carrying value shall be adjusted in AFS-Reserve.

Guidance on journal entries

Note: The guidance on journal entries is prepared for illustrative purposes only to aid banks in their understanding of the Directions. Banks may modify them suitably for their accounting systems while ensuring compliance with the Directions. For simplicity, while preparing illustrations, straight line amortisation of discount has been assumed and the effect of taxation or standard asset provisioning has been ignored.

Day 1 Loss in HTM and amortisation of discount

Q.No.25: A bank has acquired a debt security with the objective to hold till maturity (HTM). The security meets the SPPI criteria with following particulars:

- **Face Value: ₹ 100, coupon: 5%, Residual tenor: 5 years**
- **Acquisition cost: ₹ 95, Fair Value at time of acquisition: ₹ 75**

How is the discount on a debt security determined? How will the discount be amortised over the remaining tenor?

(Refer Clause 9 and 12(b) of Directions)

Ans: At initial recognition, there is a Day 1 loss of ₹ 20 which needs to be recognised immediately. Consequently, the value at which the security is recognised is ₹ 75. The accounting entries on the date of acquisition would be as under:

	Particulars	**Debit (₹)**	**Credit (₹)**
At initial recognition	Investment Dr.	75	
	Day 1 Loss (P&L) Dr.	20	
	To Cash/ Bank		95
	(Being acquisition of security of face value ₹100 and fair value ₹75 for ₹95.)		

The discount (i.e., difference between Face Value and amount initially recognised in the books) is ₹ 25. This can be amortised over the remaining maturity on a straight line or constant yield method depending upon the systems and policy of the bank. Assuming the bank has been following a straight-line method, the annual accrual works out to ₹5 (i.e., ₹25 ÷ 5 years) per year.

The accounting entries would be as under:

	Particulars	**Debit (₹)**	**Credit (₹)**
Subsequently every year[45] till maturity	Investment Dr. Cash/ Bank Dr. To Interest earned (P&L) (Being receipt of coupon and accrual of discount)	5 5	 10

[45] Banks can also pass entries for accrued interest (i.e., accrued coupon and discount) on reporting date.

Carrying value and amortisation of discount under AFS

Q.No.26: A bank has acquired a debt security on 1-April-X1 having following particulars and meeting SPPI criterion.

- **Face Value: ₹ 100, coupon: 5%, Residual tenor: 5 years**
- **Acquisition cost: ₹ 90 Fair Value at time of acquisition: ₹ 90**
- **Fair value as at 31-Mar-X2 = ₹ 88**
- **Fair value as at 31-Mar-X3 = ₹ 96**
- **Fair value as at 31-Mar-X4 = ₹ 98 and security is sold on 31-Mar-X4 at fair value of ₹ 98.**

The security is held under AFS.

(Refer Clause 13(a) and (b) of Directions)

Ans:

The accounting entries on the date of acquisition would be as under:

	Particulars	Debit (₹)	Credit (₹)
1-April-X1	Investment Dr. To Cash/ Bank (Being acquisition of security of face value ₹100 and fair value for ₹90)	90	90

At each reporting date, assuming straight line amortisation, movement of carrying value of the debt security would be as under:

Reporting Date	Opening Carrying value of investment	Interest income (Coupon + Amortisation of discount)	Cash inflow (Coupon Receipt)	Carrying value of investment	Fair value of investment at reporting date	Gain/loss recognised in AFS-Reserve	Closing Carrying value of investment	Accumulated gain/loss in AFS-Reserve
(a)	(b)	(c)	(d)	(e)= (b)+(c)-(d)	(f)	(h) = (f) - (e)	(i) = (e) + (h)	(j)
31-Mar-X2	90	7[46]	5[47]	92	88	-4	88	-4
31-Mar-X3	88	7	5	90	96	6	96	2[48]
31-Mar-X4	96	7	103[49]	-	-	-	-	-[50]

The accounting entries would be as under:

	Particulars	Debit (₹)	Credit (₹)
31-Mar-X2	Cash/ Bank Dr.	5	
	Investment Dr.	2	
	To Interest earned (P&L)		7
	(Being receipt of coupon and accrual of discount on the investment)		

46 Includes ₹ 2 amortisation of discount and ₹ 5 coupon

47 Receipt of coupon on debt security i.e., 5% of ₹ 100 = ₹ 5

48 Accumulated gain/loss in AFS-Reserve = Accumulated gain/loss in AFS-Reserve in previous year + Gain/loss recognised in AFS-Reserve in current year

49 Includes cash inflow on sale of investment of ₹ 98 and coupon of ₹ 5

50 Accumulated gain/loss in AFS-Reserve is recycled to profit and loss account on sale of debt security

	Particulars	Debit (₹)	Credit (₹)
	AFS-Reserve Dr To Investment (Being fair value loss on investment) recognised in AFS-Reserve	4	4
31-Mar-X3	Cash/ Bank Dr. Investment Dr. To Interest earned (P&L) (Being receipt of coupon and accrual of discount on the investment)	5 2	7
	Investment Dr To AFS-Reserve (Being fair value gain on investment) recognised in AFS-Reserve	6	6
31-Mar-X4	Investment Dr. Interest accrued Dr. To Interest earned (P&L) (Being accrual of coupon and discount on the investment)	2 5	7
	Cash/ Bank Dr. AFS-Reserve Dr. To Investment To Interest accrued To Profit on sale of investment (P&L) (Being receipt of coupon and sale proceeds, accrual of discount and recycling of gains accumulated in AFS-Reserve to P&L A/C)	103 2	98 5 2

Carrying value under FVTPL

Q.No.27: A bank has acquired a debt security on 1-April-X1 having following particulars for trading.

- **Face Value: ₹ 100, coupon: 5%, Residual tenor: 5 years**
- **Acquisition cost: ₹ 90, Fair Value at time of acquisition: ₹ 90**
- **Fair value as at 31-Mar-X2 = ₹ 95**
- **Fair value as at 31-Mar-X3 = ₹ 92**

(Refer Clause 14 of Directions)

Ans:

The accounting entries on the date of acquisition would be as under:

	Particulars	**Debit (₹)**	**Credit (₹)**
1-April-X1	Investment Dr. To Cash/ Bank (Being acquisition of security of face value ₹100 and fair value for ₹90)	90	 90

As the debt security is acquired for trading, it shall be classified under HFT. The movement in carrying value of security would be as under:

Reporting Date	Opening Carrying value of investment	Interest income (Coupon + Amortisation of discount)	Cash inflow (Coupon Receipt)	Carrying value of investment	Fair value of investment at reporting date	Fair value gain/loss recognised in P&L A/C	Closing Carrying value of investment
(a)	**(b)**	**(c)**	**(d)**	**(e)= (b)+(c)-(d)**	**(f)**	**(h) = (f) - (e)**	**(i)=(e)+(h)**
31-Mar-X2	90	7	5	92	95	3	95
31-Mar-X3	95	7	5	97	92	-5	92

The accounting entries would be as under:

	Particulars	Debit (₹)	Credit (₹)
31-Mar-X2	Investment Dr. Cash/ Bank Dr. To Interest earned (P&L) (Being receipt of coupon and accrual of discount on the investment)	2 5	 7
	Investment Dr To Profit on revaluation of investments (P&L) (Being fair valuation on security)	3	 3
30-Sep-X1	Investment Dr. Cash/ Bank Dr. To Interest earned (P&L) (Being receipt of coupon and accrual of discount on the investment)	2 5	 7

	Particulars	Debit (₹)	Credit (₹)
	Loss on revaluation of investment (P&L) Dr. To Investment (Being fair valuation of Security)	5	5

Non-Performing Investment (NPI) under HTM

Q.No.28: A bank has acquired a debt security on April 1, 20X1 having following particulars.

- **Face Value: ₹ 100, coupon: 5%, Residual tenor: 5 years**
- **Acquisition cost: ₹ 90, Fair Value at time of acquisition: ₹ 90**
- **Fair value as at 31-Mar-X2 = ₹ 94**
- **Fair value as at 31-Mar-X3 = ₹ 75 and debt security is classified as substandard asset requiring provision of 15 per cent as per IRACP norms.**
- **Fair value as at 31-Mar-X4 = ₹ 72 and debt security is classified as doubtful asset requiring provision of 25 per cent as per IRACP norms.**

The security is held under HTM.

(Refer Clause 12(b), 36(c), 36(d) of Directions)

Ans: The accounting entries on the date of acquisition would be as under:

	Particulars	Debit (₹)	Credit (₹)
1-April-X1	Investment Dr. To Cash/ Bank (Being acquisition of security of face value ₹100 and fair value for ₹90)	90	 90

At each reporting date, assuming straight line amortisation, movement of carrying value of the debt security would be as under:

Reporting Date	**Opening Carrying value of investment**	**Interest income**	**Cash inflow**	**Carrying value of investment**	**Fair value of investment at reporting date**	**Provision as per IRACP norms**	**Provision for depreciation in value of Investment**	**Provisions to be made**	**Provision held already**	**Provisions to be charged to P&L A/C**	**Closing Carrying value of investment**
(a)	(b)	(c)	(d)	(e)= (b)+(c)-(d)	(f)	(g) = Carrying value on default * (Provision as per IRACP norms) %	(h) = Carrying value on default – Fair value on reporting date	(i) = MAX (g, h)	(j)	(k) = (i) – (j)	(l) = (e)-(i)
31-Mar-X2	90	7	5	92	94[51]	-	-	-	-		92[52]
31-Mar-X3	92	-	-	92	75	14[53]	17[54]	17	-	17	75
31-Mar-X4	75	-	-	75	72	23[55]	20[56]	23	17	6	69

[51] This fair value is not relevant for provisioning since the investment is held under HTM and has not been classified as NPI.

[52] The closing value in this case is the cost adjusted for amortisation of discount as the security has not been classified as an NPI. Therefore, "(l)=(e) – (i)" given in the column header is not relevant here.

[53] IRACP norms would require a provision of 15% of ₹92 i.e., ₹14.

[54] Provision for depreciation of investment = Carrying value of investment on default i.e., ₹92 – Fair value on reporting date i.e., ₹75 = ₹17

[55] IRACP norms would require a provision of 25% of ₹92 i.e., ₹23.

[56] Provision for depreciation of investment = Carrying value of investment on default i.e., ₹92 – Fair value on reporting date i.e., ₹72 = ₹20

The accounting entries would be as under:

	Particulars	Debit (₹)	Credit (₹)
31-Mar-X2	Cash/ Bank Dr. Investment Dr. To Interest earned (P&L) (Being receipt of coupon and accrual discount)	5 2	 7

On investment becoming NPI:

	Particulars	Debit (₹)	Credit (₹)
31-Mar-X3	Provisions for NPI (P&L) Dr. To Provision held[57] on NPI (Being provision for NPI)	17	 17
31-Mar-X4	Provisions for NPI (P&L) Dr. To Provision held on NPI (Being provision for NPI)	6	 6

[57] The provision held on NPI shall be reduced from investments while presenting on the Balance Sheet.

Non-Performing Investment (NPI) under AFS

Q.No.29: A bank has acquired a debt security on 1-April-X1 having following particulars.

- **Face Value: ₹ 100, coupon: 5%, Residual tenor: 5 years**
- **Acquisition cost: ₹ 90, Fair Value at time of acquisition: ₹ 90**
- **Fair value as at 31-Mar-X2 = ₹ 94**
- **Fair value as at 31-Mar-X3 = ₹ 75 and debt security is classified as substandard asset requiring provision of 15 per cent as per IRACP norms.**
- **Fair value as at 31-Mar-X4 = ₹ 85 and debt security is classified as doubtful asset requiring provision of 25 per cent as per IRACP norms.**

The security is held under AFS.

(Refer Clause 13(b), 36(c), 36(d) of Directions)

Ans:

The accounting entries on the date of acquisition would be as under:

	Particulars	**Debit (₹)**	**Credit (₹)**
1-April-X1	Investment Dr. To Cash/ Bank (Being acquisition of security of face value ₹100 and fair value for ₹ 90)	90	90

At each reporting date, assuming straight line amortisation, movement of carrying value of the debt security would be as under:

Reporting Date	Opening Carrying value of investment	Interest income	Cash inflow	Carrying value including discount accrued and cash inflows	Fair value of investment at reporting date	Amount recognised in AFS - Reserve during the year	Provision required as per IRACP norms	Provision for depreciation required vis-à-vis NPI date	Provisions to be made	Provision already held	Provision to be made in current year	Provisions to be charged against accumulated gains available in AFS-Reserve	Provisions to be charged to P&L A/C	Accumulated gains/loss in AFS Reserve	Closing Carrying value of investment
(a)	(b)	(c)	(d)	(e)= (b)+(c)-(d)	(f)	(g)	(h) = Carrying value on default * (Provision as per IRACP norms) %	(i) = Carrying value on default – Fair value on reporting date	(j) = MAX (h, i)	(k)	(l) = (j)-(k)	(m)	(n) = (l)-(m)	(o)	(p) = (e)+(g)-(m)-(n)
31-Mar-X2	90	7	5	92	94	2	-	-	-	-	-	-	-	2	94
31-Mar-X3	94	-	-	94	75	-	14	19	19	-	19	2[58]	17	-	75
31-Mar-X4	75	-	-	75	85	-	24	9	24	19	5	-	5	-	70

[58]The provision required may be created by charging the same to AFS-Reserve to the extent of such available gains. In this case as accumulated gains in AFS-Reserve at close of previous year was ₹ 2. Therefore, provision to the extent of ₹ 2 can be charged to AFS-Reserve.

The accounting entries would be as under:

	Particulars	Debit (₹)	Credit (₹)
31-Mar-X2	Cash/ Bank Dr. Investment Dr. To Interest earned (P&L) (Being receipt of coupon and accrual of discount on investment) Investment Dr To AFS-Reserve (Being fair value gain on investment)	5 2 2	 7 2
31-Mar-X3	Provisions (P&L) Dr. AFS-Reserve Dr. To Provision held on NPIs (Being provisions for NPIs)	17 2	 19
31-Mar-X4	Provisions (P&L) Dr. To Provision held on NPIs (Being provisions for NPIs)	5	 5

Q No. 30: A bank has acquired a debt security on 1-April-X1 having following particulars.

- **Face Value: ₹ 100, coupon: 5%, Residual tenor: 5 years**
- **Acquisition cost: ₹ 90, Fair Value at time of acquisition: ₹ 90**
- **Fair value as at 31-Mar-X2 = ₹ 85**
- **Fair value as at 31-Mar-X3 = ₹ 80 and debt security is classified as substandard asset requiring provision of 15 per cent as per IRACP norms.**
- **Fair value as at 31-Mar-X4 = ₹ 60 and debt security is classified as doubtful asset requiring provision of 25 per cent as per IRACP norms.**

The security is held under AFS.

(Refer Clause 13(b), 36(c), 36(d) of Directions)

Ans:

The accounting entries on the date of acquisition would be as under:

	Particulars	**Debit (₹)**	**Credit (₹)**
1-April-X1	Investment Dr. To Cash/ Bank (Being acquisition of security of face value ₹100 and fair value for ₹ 90)	90	90

At each reporting date, assuming straight line amortisation, movement of carrying value of the debt security would be as under:

Reporting Date	Opening Carrying value of investment	Interest income	Cash inflow	Carrying value including discount accrued and cash inflows	Fair value of investment at reporting date	Amount recognised in AFS - Reserve during the year	Provision required as per IRACP norms	Provision for depreciation required vis-à-vis NPI date	Provisions to be made	Provision already held	Provision to be made in current year	Provisions for accumulated losses in AFS-Reserve	Provisions to be charged to P&L A/C	Accumulated gains/loss in AFS Reserve	Closing Carrying value of investment
(a)	(b)	(c)	(d)	(e)= (b)+(c)-(d)	(f)	(g)	(h) = Carrying value on default * (Provision as per IRACP norms) %	(i) = Carrying value on default – Fair value on reporting date	(j) = MAX (h, i)	(k)	(l) = (j)-(k)	(m)	(n) = (l)-(m)	(o)	(p) = (e)+(g)-(m)-(n)
31-Mar-X2	90	7	5	92	85	-7	-	-	-	-	-	-	-	-7	85
31-Mar-X3	85	-	-	85	80	-	13	5	13	-	13	-7[59]	20	-	72
31-Mar-X4	72	-	-	72	60	-	21	25	25	13	12	-	12	-	60

[59] In the case of an investment categorised under AFS against which there are cumulative losses in AFS-Reserve, the cumulative losses shall be transferred from AFS-Reserve to the Profit and Loss Account. In this case as accumulated loss in AFS-Reserve at close of previous year was ₹ 7. Therefore, ₹ 7 should be charged to P&L Account on debt security becoming NPI.

The accounting entries would be as under:

	Particulars	Debit (₹)	Credit (₹)
31-Mar-X2	Cash/ Bank Dr. Investment Dr. To Interest earned (P&L) (Being receipt of coupon and accrual of discount on investment)	5 2	 7
	AFS-Reserve Dr. To Investment (Being fair value loss on investment recognised in AFS-Reserve)	7	 7
31-Mar-X3	Provisions (P&L) Dr. To AFS-Reserve To Provision held on NPIs (Being reversal of cumulative losses in AFS-Reserve and provisions for NPIs)	20	 7 13
31-Mar-X4	Provisions (P&L) Dr. To Provision held on NPIs (Being provisions for NPIs)	12	 12

Non-Performing Investment (NPI) under AFS subsequently upgraded

Q.No.31: A bank has acquired a debt security on 1-April-X1 having following particulars.

- **Face Value: ₹ 100, coupon: 5%, Residual tenor: 5 years**
- **Acquisition cost: ₹ 85, Fair Value at time of acquisition: ₹ 85**
- **Fair value as at 31-Mar-20X2 = ₹ 90**
- **Fair value as at 31-Mar-20X3 = ₹ 80 and debt security is classified as substandard asset requiring provisions of 15 per cent as per IRACP norms.**
- **Fair value as at 31-Mar-20X4 = ₹ 97 and upgraded to standard asset.**
- **Fair value as at 31-Mar-20X5 = ₹ 97**

The security is held under AFS.

(Refer Clause 13(b), 36(c), 36(d) and 36(e) of Directions)

Ans:

The accounting entries at the acquisition date of securities would be as under:

	Particulars	Debit (₹)	Credit (₹)
1-April-X1	Investment Dr. To Cash/ Bank (Being acquisition of security of face value ₹100 and fair value for ₹85)	85	 85

At each reporting date, assuming straight line amortisation, movement of carrying value of the debt security would be as under:

Reporting Date	Opening Carrying value of investment	Interest income	Cash inflow	Carrying value including discount accrued and cash inflows	Fair value of investment at reporting date	Amount recognised in AFS - Reserve during the year	Provision required as per IRACP norms	Provision for depreciation required vis-à-vis NPI date	Provisions to be made	Provision already held	Provision to be made in current year	Provisions to be charged against accumulated gains available in AFS-Reserve	Provisions to be charged to P&L A/C	Accumulated gains/loss in AFS Reserve	Closing Carrying value of investment
(a)	(b)	(c)	(d)	(e)= (b)+(c)-(d)	(f)	(g)	(h) = Carrying value on default * (Provision as per IRACP norms) %	(i) = Carrying value on default – Fair value on reporting date	(j) = MAX (h, i)	(k)	(l) = (j)-(k)	(m)	(n) = (l)-(m)	(o)	(p) = (e)+(g)-(m)-(n)
31-Mar-X2	85	8	5	88	90	2	-	-	-	-	-	-	-	2	90
31-Mar-X3	90	-	-	90	80	-	14	10	14	-	14	2	12	-	76
31-Mar-X4	76	16	10	82	97	3[60]	-	-	-	14	-14	-	-12[61]	3	97
31-Mar-X5	97	8	5	100	97	-3	-	-	-	-	-	-	-	-	97
31-Mar-X6	97	8	105	-	-	-	-	-	-	-	-	-	-	-	-

[60] When debt security is upgraded and previously charged provision to P&L account is reversed, the carrying value of security becomes ₹ 94. However, fair value of the security on reporting date is ₹ 97. Therefore, gain of ₹ 3 would be recognised in AFS-Reserve.

[61] The amount represents the reversal of provisioning previously charged to the Profit & Loss Account. Therefore, the column header of '(n)=(l)-(m)' is not applicable.

The accounting entries would be as under:

	Particulars	Debit (₹)	Credit (₹)
31-Mar-X2	Cash/ Bank Dr. Investment Dr. To Interest earned (P&L) (Being receipt of coupon and accrual of discount on investment) Investment Dr. To AFS-Reserve (Being fair value gain on investment recognised in AFS-Reserve)	5 3 2	 8 2
31-Mar-X3	Provisions (P&L) Dr. AFS-Reserve Dr. To Provision held on NPIs (Being provision for NPI charge to P&L and previously recognised gains in AFS-Reserves)	12 2	 14
31-Mar-X4	Provision held on NPIs Dr. To Provisions (P&L) (Being reversal of previously recognised provisions for NPIs) Cash/ Bank Dr. Investment Dr. To Interest earned (P&L) (Being receipt of coupon and accrual of discount on investment on upgrade (including for the period that the investment was an NPI)) Investment Dr. Provision held for NPI Dr. To AFS-Reserve (Being fair value gain on investment recognised in AFS Reserve)	12 10 6 1 2	 12 16 3

	Particulars	Debit (₹)	Credit (₹)
31-Mar-X5	Cash/ Bank Dr. Investment Dr. To Interest earned (P&L) (Being accrual of coupon and discount on investment) AFS-Reserve Dr To Investment (Being fair value loss on investment recognised in AFS-Reserve)	5 3 3	 8 3
31-Mar-X6	Cash/ Bank Dr. To Interest earned (P&L) To Investment (Being receipt of maturity proceeds with final coupon and accrual of discount on investment)	105	 8 97