Inflation Indexed Bonds (IIBs) – Accounting Issues

Issues raised by FIMMDA and RBI's Responses

1. How will the daily changes in the inflation adjusted principal be accounted for , regarding
    a) MTM
    b) Interest
    c) Book Value

Ans: **The valuation criteria as specified for HTM, AFS and HFT would apply.**

Valuation (para nos. given are from our MC on investments)

3.1 **Held to Maturity**

i) Investments classified under HTM need not be marked to market and will be carried at acquisition cost, unless it is more than the face value, in which case the premium should be amortised over the period remaining to maturity. The banks should reflect the amortised amount in 'Schedule 13 - Interest Earned: Item II - Income on Investments', as a deduction. However, the deduction need not be disclosed separately. The book value of the security should continue to be reduced to the extent of the amount amortised during the relevant accounting period.

In the case of IIBs, face value will mean the inflation adjusted principal.

3.2 **Available for Sale**

The individual scrips in the Available for Sale category will be marked to market at quarterly or at more frequent intervals. Domestic Securities under this category shall be valued scrip-wise and depreciation / appreciation shall be aggregated for each classification referred to in item 2(i) above and foreign investments under this category shall be valued scrip-wise and depreciation / appreciation shall be aggregated for five classifications (viz. Government securities (including local authorities), Shares, Debentures & Bonds, Subsidiaries and / or joint ventures abroad and Other investments (to be specified)). Further, the investment in a particular classification, both in domestic and foreign securities, may be aggregated for the purpose of arriving at net depreciation / appreciation of investments under that category. Net depreciation, if any, shall be provided for Net appreciation, if any, should be ignored. Net depreciation required to be provided for in any one classification should not be reduced on account of net appreciation in any other classification. The banks may continue to report the foreign securities under three categories (Government securities (including local authorities), Subsidiaries and / or joint ventures abroad and other investments (to be specified)) in the balance sheet. The book value of the individual securities would not undergo any change after the marking of market.

3.3 **Held for Trading**

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

FIMMDA has informed that the price quoted in the market will be the real price and consideration for purchase and sale of the bond will be ((“Real *Price x Index Ratio*” which is clean price) + (Accrued Interest which is the *Broken Period Interest*). As per para 5.2 of the Master Circular on Classification, Valuation and Investment Portfolio by banks, broken period interest should not be capitalized but treated as an item of expenditure. In order to be consistent with present valuation norms, only clean price may be considered as acquisition cost.

As regards the mark to market value, in the case of IIBs it is the quoted clean price if available. If it is unquoted, FIMMDA’s valuation methodology for arriving at the clean price as above should be followed.

However, regarding broken period interest, banks would have to be guided by what is indicated in para 5.2 of MC on investments:

5.2 **Broken Period Interest**

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

In case it falls under unquoted SLR security, FIMMDA’s valuation methodology for arriving at the clean price should be followed.

2. RBI may please clarify the treatment of MTM appreciation /depreciation of the IIBs, whether this would form a separate classification or a part of the

Government Securities ‘classifcation’ and the appreciation/depreciation netted out with other G.Secs under this classification.

Ans: IIBs are government securities and as such should be classified accordingly as indicated in para 2 (i) of Master circular on investments:

Classification

i) The entire investment portfolio of the banks (including SLR securities and non-SLR securities) should be classified under three categories

viz. 'Held to Maturity',

'Available for Sale' and 'Held for Trading'.

* However, in the balance sheet, the investments will continue to be disclosed as per the existing six classifications:

viz. a) Government securities,

b) Other approved securities,

c) Shares,

d) Debentures & Bonds,

e) Subsidiaries / joint ventures and

f) Others (CP, Mutual Fund Units, etc.).

3. As the ‘Principal’ (Face Value) would change in the secondary market trades , the methodology for accounting the change in the ‘Principal’ (Face Value) due to Inflation Indexation needs to be clearly spelt out .

Ans: IIBs classified under AFS and HFT may be valued at clean price quoted in the market at the time of acquisition. At the time of subsequent mark to market, the clean price quoted in the market as available from trades/quotes or clean price provided by FIMMDA may be treated as market value. Once this market value has been determined, the standard accounting procedures as applicable to HFT/AFS may be applied.

4. A confirmation is required that the IIBs will be accounted for as lower of Cost or Market Value. The Market Value being the Principal after the Indexation as

on date of the trade, and the price concluded between the Buyer and Seller based upon the “Real Yield”.

Ans: As to what is market value, please refer to the answer given against Q1 and 3.

5. What would be the methodology for calculating the standardized market risk capital charge for Banks and PDs .

Ans:Presently market risk capital charge for Government Securities is calculated using Standardized Duration Method. This method is based on the price sensitivity with respect to nominal interest rates (modified duration). This methodology may be made applicable to IIBs also. Nominal interest rates are composed of two factors: real interest rates and inflation expectations. IIBs are exposed to the risk of changes in the real rates only. Therefore, price sensitivity calculated with respect to nominal yields will not provide the true risk of the IIBs. Hence in the case of IIBs, price sensitivity with respect to change in the real yields should be calculated for IIBs.

6. The principal for the IIBs is supposed to be indexed to the increase in the inflation as worked out by multiplication of the “Index Ratio” with the face value of the bond. Once the bond starts trading in the market after the auction, the index ratio will be changing daily and so also, the principal amount on which the fixed coupon will be accruing of the bond. Kindly clarify how to account for the principal and the interest for an IIB purchased in the secondary market.

Ans: Answers as given in Q 1 and Q 3.

7. What would be the SLR treatment for the mark-to-market appreciation in the IIB. Would an increased principal due to MTM be eligible for increase in SLR for the Bank holding the IIB.

Ans: Valuation methodology for IIBs has been explained above. Other than that no change is considered.

8. Kindly advise the accounting procedure for provisioning for MTM increase or decrease for the IIB acquired in the primary auction or the secondary market.

Ans: Valuation and accounting methodology as given in the answers to above questions.