INVESTMENT FLUCTUATION RESERVE FOR UCBs

1. Investment portfolio maintained by banks is susceptible to market risk, as the market value of securities can fluctuate depending upon the market factors, such as yield, liquidity, spread, etc.

2. As per the regulatory guidelines, the investment portfolio can be maintained in three categories, namely, Held to Maturity (HTM), Held for Trading (HFT), and Available for Sale (AFS). While HTM is referred to as banking book, the investment held in HFT, and AFS is termed as Trading Book.

3. In accordance with regulatory guidelines, no valuation loss is recognised in the banking book, but the same is to be recognised and accounted for in the trading book.

4. A provision made against valuation loss, known as marked to market loss, by debit to banks' Profit & Loss Account is termed as Investment Depreciation Reserve (IDR). Besides, to guard against any adverse movement in securities' prices in future, an Investment Fluctuation Reserve (IFR) is made, which is recognised as a Tier II capital for Urban Cooperative Banks (UCBs).

5. The purpose of making IFR in addition to IDR lies in an understanding of expected and unexpected losses. While IDR provides for expected losses occurring in the ordinary course of business, the creation of IFR enables banks to endure the possibility of unexpected losses due to fluctuation in the securities prices, and consequent volatility of the balance of profit.

6. As per regulatory guidelines, all UCBs should create IFR out of realised gain on sale of securities, subject to availability of net profit through the appropriation account after appropriation to Statutory Reserve, for a minimum value of 5% of the book value of their investments held in HFT and AFS categories. While creating IFR, no unrealised gain should be taken to income account or the IFR. Any addition to or drawdown from the IFR must be a 'below the line' transaction. To put it simply, any addition to or drawdown from the IFR should not impact any income, expenditure, tax, or net profit.

7. It is possible to draw down from the IFR to smoothen the impact of the creation of IDR on the profit. In other words, if banks' profitability is adversely impacted due to substantial marked to market losses in a particular year, they can use the balance available in the IFR as per the following procedure.

8. In cases where the available IFR is more than 5% of the book value of the banks' investments in AFS/HFT category, they may decide to draw down the balance above the 5% requirement, below the line, to their balance of profit.

9. In case the available IFR is below 5% of the book value of investments in AFS/HFT, banks can draw down from the available balance of IFR up to the extent of marked to market losses and the provisions made thereof exceeds the net profit on the sale of investments during that year. In this case, the drawn down amount can be used only for appropriation to free reserves or for reducing the balance of loss.

10. Maintenance of IFR strengthens the banks' financial position and enables them to weather any unexpected volatility in their investment portfolio.

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Source:

1. RBI Master Circular on Investment Management by UCBs, Ref. DCBR. BPD (PCB).MC.No. 4/16.20.000/2015-16 dated July 01, 2015.

2. RBI Circular DCBR.BPD.(PCB/RCB)Cir.No.1/16.20.000/2018-19 dated July 06, 2018.