FIDC

Finance Industry Development Council

(A Representative Body of Assets and Loan Financing NBFCs)
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Shri. Injeti Srinivas
Secretary
Ministry of Corporate Affairs
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Dear Sir,

SUB: REPRESENTATION ON STRESSED ASSETS & IND-AS

Finance Industry Development Council (FIDC) is a Representative Body of the Assets and Loan Financing NBFCs registered with the Reserve Bank of India. FIDC was formed 15 years ago and is the recognized face of the NBFC sector. We have been engaged in regular interaction both with Reserve Bank of India and Govt. of India, which include pre-budget meetings and also important policy related meetings with RBI. Almost all the leading NBFCs and a large number of small and medium sized NBFCs are our members.

NBFCs have been playing an increasing role in extending financial services to the un-served and under-served segments in the country, especially towards small road transport operators, contractors, MSME sector and agri-related sectors. NBFCs are regulated by the RBI and critical norms for income recognition, exposure norms and risk management for NBFCs are similar to those RBI regulations for banks (to the extent these are relevant).

The SARFAESI Act was enacted in 2002 to provide inter alia, a mechanism by which banks and NBFCs could sell/transfer stressed assets to an asset reconstruction company ("ARC") in order to clear their balance sheets of non-performing loans and to ensure that the economic value of these loans could be realised in a time-bound manner. ARCs are expected to have necessary skills to ensure better recovery of such assets and hence aid in reducing the incidence of bad loans at the systemic level.

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The Act also provides for an option (not an obligation) for banks and NBFCs that transfer the stressed assets to subscribe to Security Receipts ("SR") issued by the special purpose vehicle under the management of the ARC which holds the transferred stressed assets. These SRs are fair-valued on a periodical basis and any impairment is accounted for in order to present a true and fair picture of such investments in SRs. These SRs are freely transferable and holding of these by the NBFC is purely voluntary. These SRs are accounted for as investments under the Indian GAAP.

With the implementation of Indian Accounting Standard (Ind-AS) for NBFCs, the entire accounting paradigm has undergone a significant change. We refer to the requirements under Ind AS 109, "*Financial Instruments*" with regard to derecognition of financial assets from the balance sheet of a transferor. We note that the said requirements contain a strict 'risk and rewards test' which needs to be tested in order for a transferred financial asset to be derecognized from the balance sheet of the transferor. In addition, there is also a 'control test', which needs to be applied but only in case where the transferor neither transfers nor retains substantially all the risks and rewards. Thus, in effect, the risk and rewards test precedes the control test. From a plain reading of the newer norms would suggest that the stressed loans that are transferred to an ARC cannot be derecognised on the books of the NBFC and would have to continue to be accounted for as if no such transfer took place. By implication, impairment of each such loan would have to be recognised by the NBFC in line with the expected credit losses. By implication as well, investments in SRs issued by the ARC/SPV cannot be held as investment by the said NBFC.

This creates a piquant situation where the NBFC is forced to account for an asset it does not have, but not account for an investment, actually held by it.

Being mandated under the Ind-AS to continue to show the stressed assets on the balance sheet also effectively defeats the purpose of sale of such assets under the SARFAESI Act.

It is also to be noted that Banks have currently not transitioned to Ind AS. Accordingly, currently if a portfolio with similar characteristics is sold by a bank to an ARC where "True Sale" criterion is met, the bank would be able to derecognize the loans (Financial Assets) under RBI guidance, while NBFCs cannot do so given that Ind

AS does not allow it. It is evident that this is not a fair treatment for NBFCs, given that while both the legal entities (NBFCs and Banks) are covered by the same provisions of the SARFAESI Act. We request that the anomaly be resolved suitably.

- **US GAAP Guidance -**

  Internationally, derecognition under US GAAP (ASC 860) is based on control test instead of substantial risk and rewards test.

  Derecognition of financial assets (i.e., sales treatment) occurs when effective control over the financial asset has been surrendered:

  - The transferred financial assets are legally isolated from the transferor
  - Each transferee (or, if the transferee is a securitization entity or an entity whose sole purpose is to facilitate an asset-backed financing, each holder of its beneficial interests), has the right to pledge or exchange the transferred financial assets (or beneficial interests)
  - The transferor does not maintain effective control over the transferred financial assets or beneficial interests (e.g., through a call option or repurchase agreement)

  Thus, if internationally as per US GAAP, control is assessed for derecognition and not the risk and reward, this principle may also be followed in case of securitisation transactions in India.

Conclusion:

Considering the aforesaid arguments, we believe when a specific law is available which requires certain accounting treatment to support the industry and economy as a whole, Ind AS guidance cannot override it to provide absolutely different picture to readers. Business presentation and accounting presentation cannot go in different directions.

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- Thus, we request you allow banks (whenever they transition to Ind AS) and NBFCs to recognize Investment in SRs and derecognize the financial asset (loans), if control has been transferred to an ARC. As we mentioned, this does not affect true and fair view, given that Expected Credit Loss would continue to be provided on such SRs, and the fair of SRs would reflect the expected credit loss.

- We have observed that regulators in the past (such as in the case of Para 46 & 46A of AS 11, carve out in FCCB, Ind AS 101 transition to allow Indian GAAP carrying cost for PP&E, Bargain purchase gain to recognize in equity, Appendix C to Ind AS 103, Dividend distribution tax to be recognized in equity) have supported and stood for our country's law and economic condition which prevails and have more weightage than the global standard guidance (IFRS) or Ind AS. Thus, we would request you to suggest suitable amendments to the accounting standard.

<u>Our Prayer</u>

We would request the ICAI and the MCA to amend the norms under Ind-AS in respect of the aforesaid stressed loans to

a. ***enable these to be derecognised as assets by the transferor and***
b. ***account for investments in SRs on a fair value basis as "Investments"***

We give below our reasons for such a prayer:

a. The SARFAESI Act was enacted to provide relief to banks and NBFCs to manage stressed loans in a meaningful manner and such transfers are done under those provisions
b. The loans being the assets of the ARC, must rightfully be reflected in the ARC's balance sheet and not on the transferor's
c. The risk arising from impairment of the transferred loans passes to the ARC. No credit enhancement/guarantee is provided by the transferor
d. In case the transferor also subscribes to the SRs, they assume the risk of impairment of the SRs as any third party would and hence must be allowed to account for the investment in line with the norms for investment accounting (including provision for impairment)

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e. Any loss (or profit) on transfer of the loans to the ARC would have to be accounted for in calculating the transferor's income tax liability

We would earnestly request you to consider our request. We would be grateful if you could give us an opportunity to discuss with you the aforesaid matter.

Yours Faithfully

For FINANCE INDUSTRY DEVELOPMENT COUNCIL

MAHESH THAKKAR
DIRECTOR GENERAL