BOMBAY CHAMBER
Bombay Chamber
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28th June 2021

**Shri. Ajay Kumar Choudhary**
Chief General Manager-in-Charge
Department of Supervision
Reserve Bank of India
Central Office, World Trade Centre – I
Mumbai – 400 005

Received
29/6/20
भारतीय रिज़र्व बैंक
प.वि. के.का.
मुंबई
D.O.S. C.O.
Mumbai
Reserve Bank of India

Dear Sir,

**Sub: Clarification on "Asset Size" criteria in various Guidelines issued by the Reserve Bank of India**

1. Established in 1836, the **Bombay Chamber of Commerce and Industry (BCCI)** is a not-for-profit, industry-led organization with several thousand member companies from professionally managed corporates, financial institutions, multinationals, public sector companies, SMEs and chartered accountants. The BCCI serves as an effective vehicle of communication between various regulatory agencies, corporates and the society; and contributes effectively towards overall development of its members by addressing core business issues and needs.

2. On behalf of the members, who are registered as Non-Banking Financial Companies (NBFCs), we would like to invite your kind attention to Guidelines/Circulars by the Reserve Bank of India (RBI), where there are certain clarifications required, arising from Indian Accounting Standards (Ind-AS) implementation which requires investments to be Fair Valued, with attendant impact on Asset-Value and volatility therein from year-to-year. The issue primarily affects Investment Companies since operating assets of other NBFCS, do not warrant similar upward valuation.

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3. Since "Asset-Size" is the relevant criteria in several Regulatory Circulars issued by RBI, we wish to bring to your kind notice, the clarifications needed by our member NBFCs which are in the category of NBFC-ND and NBFC-ND-SI (including CIC), in implementation of the said guidance.

   a) The "asset-size" of a supervised entity has not been explicitly defined in the regulatory guidelines and has led to an ambiguity on its application of the circular for some of the supervised entities. We draw reference to the terms "asset-size" and "asset-value".

   b) **Asset-size** of any entity is the value of the underlying assets at cost or impaired value (whichever is lower).

   c) The adoption of Ind-AS from financial year 2018-19, has led to the use of "fair valuation" of all financial instruments as per Ind-AS 109, while hitherto appreciation in portfolio value was not considered both in preparation of Financial Statements under the Companies Act as well as for computing various RBI related regulatory ratios and computing borrowing ability of the NBFCs. This stochasticity has created a "notional revaluation reserve" on the liability side, known as *Other Comprehensive income (OCI)*, which is essentially equivalent to a Revaluation Reserve, albeit annually impacted by valuation movement.

4. An important point to be noted here is, for a NBFC-Investment Company, value of such notional "revaluation reserve" may fluctuate on a year-on-year basis, and thus, lead to a situation wherein such supervised entity, after crossing the specified threshold limit of say Rs. 5,000 crore, in one year may fall below the specified threshold limit in the next year itself. Thus, it might create an ambiguity on the applicability of the circular thereon.

5. To demonstrate the effect of notional revaluation reserve on the financial statements of a supervised entity, we have considered a simplified example wherein the entity held financial instruments (investments) acquired at a Cost of say, Rs. 4,000 crore upto FY2017-18 (market value Rs. 4,500 crore as on 31st March 2018) and accounted the same at Book Value under the Indian GAAP regime of accounting (no diminution assumed) and transitions to Ind-AS.

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*(It has been assumed that the investment cost remains unchanged in terms of additional purchase, sale, or re-investment. Table 1.1 below illustrates the impact on asset-size and asset-value respectively during such transition.)*

***Table 1.1: Illustrative Balance Sheet***

| **Balance Sheet** | | IGAAP | IND-AS | | |
|---|---|---|---|---|---|
| | | 2017-18 | 2018-19 | 2019-20 | 2020-21 |
| ***Assets:*** | | ***Rs. Cr*** | ***Rs. Cr*** | ***Rs. Cr*** | ***Rs. Cr*** |
| Fixed Assets | *i* | 100 | 100 | 100 | 100 |
| Financial Instruments (Book Value) | *ii* | 4,000 | 4,000 | 4,000 | 4,000 |
| *Add: Unrealised Gains/Loss* | *iii* | - | *1,000* | - | *4,000* |
| Financial Instruments (Fair Value) | *iv* | 4,000 *(at BV)* | 5,000 *(at FV)* | 4,000 *(at FV)* | 8,000 *(at FV)* |
| Other Current Assets | *v* | 100 | 100 | 100 | 100 |
| **Total Assets** | | **4,200** | **5,200** | **4,200** | **8,200** |

6. It can be observed from the table that financial instruments have been measured at book value upto FY2017-18, although the Market Value was higher. However, during the succeeding periods, the value of such investments has from year-to-year appreciated (FY2018-19 & 2020-21) and depreciated (FY2019-20). This volatility in fair valuation of financial instruments (iv) has been adjusted under the head "unrealised gains/losses" (iii). *Ceteris paribus*, on the liability side, the dual entry is effected through OCI account.

7. In this connection, we refer to the RBI guidance issued on 13th March 2020 on implementation of *Indian Accounting Standards* [RBI/2019-20/170 DOR (NBFC).CC.PD.No.109/22.10.106/2019-20], wherein, the definition for 'owned funds', 'net owned funds' and 'regulatory capital' is noted to **exclude any unrealised gains to arrive at the owned funds**. This is in line with the past stand of RBI, viz., Revaluation Reserves are to be excluded. RBI has prescribed that the increase in value of the assets, over the cost as well as the consequential Fair Value Reserves, be ignored for determining relevant ratios; and thus, regulating the borrowing ability of the NBFC based on Actual Cost of the Financial Assets.

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8. Therefore, for the purpose of computing capital to risk-weighted asset ratio (CRAR), NBFCs are required to consider the cost or impaired value of owned funds. This is corroborated by the Form DNBS-03 (erstwhile Form NBS-7) which requires NBFCs to calculate adjusted risk-weighted assets and net owned fund to arrive at CRAR using Book value (i.e., excluding unrealised gains) instead of fair market value as disclosed in the financial statement as per Ind-AS.

9. Additionally, we infer from RBI Master Direction on *"Non-Banking Financial Company – Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016"* (updated as on 17th February 2020), that the external borrowing capability of an NBFC is linked to its CRAR and as **such borrowing limits are determined based on the Balance Sheet at Book Value**.

10. Since the borrowing capacity of the supervised entity is largely determined by its Asset-Size as appearing in its Balance Sheet, reckoned at Cost and not at Fair Value, we understand that systemic risk is similarly limited to the cost of its assets and not its fluctuating fair value.

Based on the aforesaid, we submit to the RBI that the asset size of an entity be measured at cost, or impaired value, instead of fair market value and seek issue of a suitable guidance for all regulatory compliance purposes, in line with your circular on implementation of Ind-AS.

We would be pleased to explain further the issues raised by us in this representation and address other issues you may like to discuss.

Thanking you,

Yours sincerely,

Sandeep Khosla