FIDC

Finance Industry Development Council

(A Representative Body of NBFCs in India)

101/103, Sunflower, 1st Floor, Rajawadi Road No.2, Ghatkopar (East), Mumbai – 400 077
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18th February 2025

Shri S C Murmu,
Executive Director,
Department of Supervision (DoS),
Reserve Bank of India,
Central Office Building
Shahid Bhagat Singh Road
Mumbai-400 001

Respected Sir,

SUB: REQUEST FOR REGULATORY RECONSIDERATION ON TREATMENT OF RIGHT-OF-USE (ROU) ASSETS UNDER IND AS 116

Finance Industry Development Council (FIDC), a representative body of Non-Banking Financial Companies (NBFCs) registered with the Reserve Bank of India, with a legacy of 21 years, is the recognized face of the NBFC sector, representing almost all leading NBFCs and a large number of small and medium-sized NBFCs. As an organization actively working towards being recognized as the Self-Regulatory Organization (SRO) for the NBFC sector, we are committed to promoting fair regulatory practices and accurate financial reporting for our member NBFCs. **We are writing to express our concerns regarding the treatment of Right-of-Use (ROU) assets under Ind AS 116.**

Background

Ind AS 116 requires Non-Banking Financial Companies (NBFCs) adopting Ind AS to recognize Right-of-Use (ROU) assets and corresponding lease liabilities on their balance sheets for leased properties. This accounting standard aims to ensure greater transparency in financial reporting and reflect the economic reality of leasing arrangements.

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Characteristics and Accounting Treatment of Right-of-Use (ROU) Assets

Ind AS 116 defines ROU assets as assets representing a lessee's right to use an underlying tangible asset (such as buildings, equipment, vehicles, or land) for the lease term.

Key Characteristics of ROU Assets

- **Represent a right to use a physical asset**: ROU assets give the lessee the right to use a physical asset, such as a building or equipment, for a specified period.
- **Subject to depreciation**: Like tangible assets, ROU assets are subject to depreciation, which recognize that ROU assets are depreciated over the tenure of the lease.

Accounting Treatment under Ind AS 116

- **Recognized at the commencement date of the lease**: ROU assets are recognized on the balance sheet at the commencement date of the lease, measured at the present value of lease payments, discounted using the lessee's incremental borrowing rate. A corresponding lease liability is also recognized, representing the lessee's obligation to make lease payments.
- **Depreciated over the lease term**: ROU assets are depreciated over the lease term, with the depreciation expense recognized in the profit and loss statement.
- **Interest on lease liability**: The lease liability is measured at amortized cost using the effective interest method. Interest expense on the lease liability is recognized in the profit and loss statement over the lease term.
- **Accounting at the end of the lease term**: At the end of the lease term, the ROU asset and lease liability are settled in full, resulting in their simultaneous derecognition from the balance sheet. As a result, there is no residual balance remaining in the books.

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Objective of Ind AS 116

The objective of Ind AS 116 is to provide a faithful representation of the economic benefits and costs associated with leasing an asset, including interest and depreciation expenses, and to reflect the economic reality of leasing arrangements.

Current Industry Practice

NBFCs have been treating ROU assets as tangible assets, assigning a 100% risk weight for regulatory capital adequacy computations. This treatment recognizes that ROU assets are similar to tangible assets in many respects, and that they should be subject to similar risk weights for capital adequacy purposes.

Treatment of ROUs as Intangible Assets: Key Challenges for NBFCs

We have been informed by our member NBFCs that recent regulatory inspections have resulted in the RBI treating ROU assets as "intangible assets" and deducting them from Owned Fund when computing Net Owned Fund (NOF) and Capital to Risk-Weighted Assets Ratio (CRAR). We believe that this approach may not accurately reflect the economic reality of leasing arrangements and are concerned that it may lead to an inaccurate calculation of NOF, which may impact the capital adequacy ratios of NBFCs. It would further result in idle capital having to be maintained by NBFCs over notional RoU Assets that are fully covered by a corresponding Lease Liability.

Key Concerns

1. **Inaccurate Reduction of Capital Adequacy**: The deduction of ROU assets from NOF inaccurately reduces capital adequacy. As per IND AS 116, ROU assets are created by discounting lease payments using the lessee's incremental borrowing rate, and the corresponding lease liability is recognized. Over the lease term, the lease liability is amortized, and the

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interest expense is recognized. Simultaneously, the ROU asset is depreciated over the lease term. Ultimately, both the ROU asset and the lease liability are reduced to NIL. This implies that ROU assets do not represent a permanent reduction in capital.

2. **Inappropriate Classification of ROU Assets**: ROU assets are fully backed by corresponding lease liabilities, unlike typical intangible assets. The deduction of ROU assets from Owned Fund without considering the matching liability is inconsistent with fair accounting and risk assessment principles.
3. **Disparity in Treatment Across Financial Entities**: The application of Ind AS 116 is limited to certain NBFCs, whereas banks are not required to adopt Ind AS 116. This creates a disparity in financial reporting and capital adequacy treatment between Ind AS-compliant NBFCs and other financial entities, including banks. The creation of ROU assets under Ind AS 116 is intended to provide a more accurate reflection of the economic value of leasing arrangements undertaken by Ind AS-compliant NBFCs.
4. **Inconsistency with Global Practices**: IFRS 16 and Basel III do not classify ROU assets as intangible assets.

Clarification on Treatment of ROU Provided by Basel Committee

The Basel Committee provided clarification on the treatment of Right-of-Use (ROU) assets for regulatory capital purposes. In its press release dated April 6, 2017, specifically in the FAQs on changes to leases accounting, Basel Committee stated that ROU assets should not be deducted from regulatory capital so long as the underlying asset being leased is a tangible asset ***(Copy of the said document is enclosed herewith***). This clarification is crucial in ensuring consistency in regulatory capital calculations, and we believe it warrants consideration in our regulatory framework especially since Ind AS 116 is a carve out of the global accounting standards.

Our Request

In light of the above concerns, we respectfully request the RBI to:

1. **Reconsider the classification of ROU assets**: Recognize that ROU assets are not intangible assets, but rather a reflection of the right to use an underlying asset, which is appropriately matched by a corresponding lease liability.
2. **Exclude ROU assets from NOF deduction**: By excluding ROU assets from NOF deduction, the proposed adjustment would provide a more accurate and meaningful representation of the company's Capital Adequacy.
3. **Align the regulatory treatment of ROU assets with IFRS 16 and Basel III:** Recognize ROU assets as tangible assets and apply a 100% risk weight, rather than deducting them from NOF.
4. **Allow netting of ROU assets and Lease Liabilities:** Even in the event where ROU assets are not accepted as tangible assets, since ROU Assets co-exist with and are fully provided by corresponding Lease Liabilities, permit netting of ROU Assets and Lease Liabilities at least to the extent of the value of ROU Assets. While capital adequacy is a regulatory requirement, any deduction from Owned Fund should reflect actual financial exposure rather than an accounting presentation effect. Netting RoU assets against Lease Liabilities would ensure a fairer representation of Owned Fund.
5. **Equate to treatment of Deferred Tax Asset (DTA) & Deferred Tax Liabilities (DTL):** The Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023 permits netting of DTA other than those associated with accumulated losses with corresponding DTL before deduction from Tier I Capital. Same essence can analogically be applied to ROU Assets as well.
6. **Ensure parity in capital adequacy treatment between NBFCs and banks**: Prevent unfair capital requirements for Ind AS-compliant entities.

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Conclusion

The deduction of ROU assets from Owned Fund is inconsistent with global practices and creates unfair regulatory disadvantages for NBFCs. We submit that we must not overlook the substantial impact of the sudden change in the RBI's stance after five years of implementing the new accounting system on the continuity, stability and growth of the NBFC sector. A significant portion of the capital is abruptly withdrawn without there being any real impairments to the NBFC's assets. We would further request that the subject matter be seen considering the time when Ind AS is implemented for Banks where this issue would be amplified and as a nation, we will have a situation where crores of capital will stay idle and unavailable for leverage.

We urge the RBI to reconsider the treatment of ROU assets and align it with global practices to ensure a level playing field for NBFCs in India.

Thank you for your attention to this matter. We anticipate your response and clarification, which will provide necessary clarity on this important issue.

Thanking you,

Yours Faithfully,

For **FINANCE INDUSTRY DEVELOPMENT COUNCIL**

MAHESH THAKKAR
DIRECTOR GENERAL