

Query No. 42

Subject: Accounting and related disclosure of Settlement Guarantee Mechanism (SGM) in Financial Statements - [Collateral received from Member Banks as 'Liability' and Investment in Fixed Deposits of the collateral amount as 'Asset'] under Ind AS framework.¹

A. Facts of the Case

1. N Corporation (hereinafter referred to as 'the Corporation' or 'the Company'), an umbrella organisation for operating retail payments and settlement systems in India, has been an initiative of the Reserve Bank of India (RBI) and Indian Banks' Association (IBA) under the provisions of the Payment and Settlement Systems Act (PSS Act), 2007, for creating a robust payment and settlement infrastructure in India. The Corporation is regularly assessed to tax since Assessment Year (A.Y.) 2010-11 and is a registered entity under section 12AB whereby claiming exemption under section 11 of Income-tax Act, 1961. As required by the PSS Act, 2007, atleast 51% shareholding is required to be held by Public Sector Banks (PSB).

2. The Corporation, in its role as central payment system operator, had constituted the Settlement Guarantee Mechanism (SGM) for ensuring liquidity to meet any settlement obligations in the event of any default or liquidity crunch faced by any participant Member Bank. The mechanism has been approved by the RBI from time to time. The same is under the provisions of section 23 of the Payment and Settlement System Act, 2007. The Corporation had proposed a Standardised SGM (ESGM) policy across all online products (NFS, IMPS, UPI, RuPay, AePS and NETC), which has been approved by the Reserve Bank of India vide its letter dated May 01, 2021. The SGM accounting involves the following:

- Receipt of collateral from Member Banks (Participants in Payment System)
- Placement of these collateral as fixed deposits with Banks
- Receipt of interest and TDS thereon
- Payment of related expenses like line of credit expense, credit rating expense, cost of manpower managing the fixed deposits etc.

3. The Corporation has been cognizant of the potential risks associated with payment systems such as NFS/ATM, IMPS, UPI, AEPS, NETC, NACH (credit returns), RuPay etc. To mitigate these risks, the Settlement Guarantee Fund was established. It consists of two components:

1. Line of Credit (LoC):

90% of the Settlement Guarantee Fund is arranged by the Corporation through a Line of Credit (LOC) obtained from various banks.

2. Member Contribution:

10% of the Settlement Guarantee Fund is contributed by Member Banks as cash collateral. When Member Banks join the system, they are required to contribute a

¹ Opinion finalised by the Committee on 27.12.2023.

minimum of Rs. 5 lakh per product as a joining fee, which is considered as part of the cash collateral. Collateral funds contributed by Member Banks towards the Settlement Guarantee Fund is a non-interest-bearing refundable deposit with the Corporation and consequently, shown as a 'liability'. SGM fund requirement is assessed by the Corporation's risk department at every quarter end considering last 6 months settlement value data of each bank and accordingly, basis such assessment, if any additional contribution is required, the banks are requested to contribute additional funds to the Settlement Guarantee Fund. These collateral funds as mentioned are then invested with large banks as fixed deposits and are accounted for as 'assets' in the books of the Corporation. The interest income generated from these fixed deposits is utilised towards servicing cost of Line of Credit (LOC) facility taken by the Corporation from large banks as part of SGM.

The Corporation has also issued a circular to Participant Member Banks to accept Government security as collateral and there is expectation that banks will opt for the same in near future and SGM-Cash part may come down.

4. Since the inception of SGM in the financial year (F.Y.) 2011-12, the amounts invested in the fixed deposits as part of SGM funds are shown as 'Other Bank Balances' and 'Other Financial Assets (Current)' and the amount received as SGF collateral, has been shown as 'Other financial liabilities (Non-Current)' in the financials along with the adequate disclosure in the Notes to Accounts.

5. The querist has pointed out that the other Financial Market Infrastructure (FMI) entities such as, the Clearing Corporation of India (CCIL) - regulated by RBI, National Stock Exchange Limited (NSE), Bombay Stock Exchange (Now BSE Ltd.) and Multi Commodity Exchange of India Limited (MCX) - regulated by SEBI have also been reporting settlement related collaterals on similar lines in their books of account. CCIL which is also regulated by RBI, was setup in April 2001 to provide guaranteed clearing and settlement functions for transactions in Money, G-Sec, foreign exchange and derivative markets, is the closest comparable legal entity as it operates as a clearing and settlement entity similar to the Corporation. CCIL holds Rs. 16,458 crore (approx.) collateral deposits from its members as on 31.03.2023 as per their published financials for F.Y. 2022-23. While disclosing the stated collateral deposits, CCIL follows similar accounting treatment and related disclosures as the Corporation.

6. The querist has emphasised that SGF is a core to the Corporation's settlement activity and is a must for carrying out daily settlement. Any delinking of the SGF from the Corporation may lead to liquidity risk for the payment system and have an impact on the settlement related activity. The deposits received as well as investment made therefrom are part of the Corporation's settlement activity and thus of accounting as well.

7. During the accounts audit of financial statements for F.Y. 2022-23, the Comptroller and Auditor General (CAG) had enquired that whether collateral contributions received from Member Banks under 'Liabilities' and related investments under 'Assets' have resulted in overstatement of assets and liabilities. Similarly, should the Corporation not create a separate pool of funds in line with the 'Terrorism Risk Insurance Pool' created by GIC-Re.

In response to that, the Corporation has informed that it will be referring the matter to Expert Advisory Committee (EAC) for their advice and if EAC suggests any changes, the same will be implemented from F.Y. 2023-24.

8. The querist has separately clarified as follows:
- a. In following scenarios, the SGF contribution is refundable:
 - (i) If there is excess collateral fund contributed by Member Banks than required collateral, the excess collateral amount becomes refundable to Member Banks.
 - (ii) In case Member Bank decides to offboard from the Corporation's product and services, SGF contribution is refunded back after 6 months of cooling period from the date of offboarding to recover dues from the Member Bank, if any.
 - b. There is a requirement to have Settlement Guarantee Fund which is approved and regulated by Regulator, i.e., Reserve Bank of India (RBI) and any change in the mechanism needs to be approved by Regulator. To maintain Settlement Guarantee Fund (SGF) is a regulatory requirement under which the Corporation, including Member Banks operate. The Corporation is also subject to PFMI (Principles for Financial Market Infrastructures) audits and as per PFMI guidelines, the Member Bank, being one of the important stakeholders in the ecosystem, is required to contribute collateral.

As an ongoing settlement activity, it is highly unlikely that the fund would be discontinued. In an extremely far-fetched situation if it is closed, then the 'principal' amount would be returned to all the contributor Member Banks.
 - c. With regard to possibility of deficit in SGF, the querist has clarified that insufficient SGF is not possible as the Corporation has implemented NDC (Net Debit Cap) across all the direct Member Banks. NDC limits are maximum 50% of the available SGF funds. Hence, the Corporation will always have sufficient SGF to cover the settlement default.
 - d. In case the income from investment of amounts received as collateral funds is insufficient to meet the cost of servicing of LOC, the same is borne by the Corporation and in case the income is more than the cost of servicing cost of LOC, then the same will be utilised towards the SGM only.

B. Query

9. In view of the above, an opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of the India (ICAI) has been sought as to:
- (a) Whether accounting treatment of SGM collateral received from the Member Banks as 'Liabilities' and investment of these SGM collateral deposit in fixed deposits as 'Assets' in the financial statements is in accordance with paragraph 15 of Ind AS 1, 'Presentation of Financial Statements' which stipulates that "Financial statements shall present a true and fair view of the financial position, financial performance and cash flows of an entity".
 - (b) Alternate accounting and disclosure method to be followed, if any.
 - (c) Does the Corporation need to create a pool of funds in line with 'Terrorism Risk Insurance Pool' created by GIC Re and keep separate accounting of interest earned from the pool funds, TDS and any tax refund thereon.

- (d) In case of option (b) & (c), how the existing accounting can be dealt with to reflect the required disclosures.

C. Points considered by the Committee

10. The Committee notes that the basic issues raised in the query pertain to recognition of the collateral contribution received from Member Banks (Participants in Payment System) towards Settlement Guarantee Fund (SGF) in line with the policy approved by the RBI pursuant to the requirements of PSS Act, 2007 as 'liability' and the related investments made by the Corporation/Company as 'asset' in its financial statements. The Committee has, therefore, considered only these issues and has not considered any other issue that may arise from the Facts of the Case, such as, creation of SGF, accounting for the Company's obligation of settlement in case of default by a Member Bank, determination of the amount to be contributed to SGF, measurement of collateral contribution/investments, accounting by the Member Bank, accounting for LoC arrangements, presentation as per the requirements of Schedule III to the Companies Act, 2013 including presentation of amount received as SGF collateral as 'other financial liabilities (Non-Current)', etc. The Committee has answered the issue only from accounting perspective and not from legal perspective, such as, legal interpretation and compliances of PSS Act, RBI Regulations, etc. Further, though the querist has referred to the accounting treatment being accorded by CCIL and GIC Re, the Committee has restricted itself to the issues raised by the querist in the financial statements of the Corporation and has not examined the accounting being followed by other entities including appropriateness of creation of 'Terrorism Risk Insurance Pool' by GIC Re.

Furthermore, the Standards referred to hereinafter are Indian Accounting Standards (Ind ASs), notified under the Companies (Indian Accounting Standards) Rules, 2015, as revised/amended from time to time.

11. The Committee notes that the RBI is the regulatory authority for the Company, which is a licensed central payment system operator; and that there is a requirement to have Settlement Guarantee Fund (SGF) which is approved and regulated by the Regulator, viz., the RBI and any change in the mechanism also needs to be approved by the RBI. SGF is effectively a pool of funds, required to be maintained by the Company through contributions from its Member Banks, and will be used as a fallback guarantee mechanism to enable the Company as a licensed payment system operator to meet any contingency arising due to failure of a Member Bank in fulfilling its obligation of settlement.

Further, the Committee notes from the Facts of the Case that pursuant to the PSS Act, 2007, the Company has a standardised SGM policy, which is approved by the RBI, salient features of which are as follows:

- a. The settlement guarantee fund will have the following components:
 - Member Contribution towards collateral – Contribution of 10% of the total required SGF will be collected from Member Banks in the ratio of their transaction throughput of past 3 months towards collateral contribution
 - For the remaining 90% of the SGF, the Company will establish a Line of Credit (LoC) arrangement with multiple banks

- b. The funds collected by way of (a) above, will be invested as per the Company's investment policies. The income so generated would be used towards servicing cost of LoC facility
- c. In the event of any failure in settlement, LoC shall be invoked to the extent of defaulted amount. Additionally, member contribution which is also part of SGF will be utilised if required at the time of settlement default
- d. The SGF contribution is refundable to a Member Bank in the following scenarios:
 - If there is excess collateral fund contributed by Member Bank than required – in that case, the excess collateral amount becomes refundable to the Member Bank.
 - In case Member Bank decides to offboard, SGF contribution is refunded back after 6 months of cooling period from the date of offboarding to recover dues from the Member Bank, if any.
- e. In case the settlement guarantee fund is closed (which, as per the Company, is an extremely far-fetched situation), the 'principal' amount would be returned to all the contributor Member Banks.
- f. In case the interest income generated from the fixed deposits made out of the collateral funds is insufficient to meet the cost of servicing of LOC, the deficit is borne by the Company and in case the income is more than the cost of servicing cost of LOC then excess will be utilised towards the SGF.

From the above features and the Facts of the Case provided by the querist, the Committee notes that the objective of SGF is to guarantee the settlement of transactions in the event of default by a Member Bank without affecting the normal settlement process.

12. The Committee notes the following extracts from the Conceptual Framework for Financial Reporting under Indian Accounting Standards (Conceptual Framework), issued by the ICAI:

- “4.3 An asset is a present economic resource controlled by the entity as a result of past events.
- 4.4 An economic resource is a right that has the potential to produce economic benefits.”
- “4.16 An economic resource could produce economic benefits for an entity by entitling or enabling it to do, for example, one or more of the following:
 - (a) receive contractual cash flows or another economic resource;
 - (b) exchange economic resources with another party on favourable terms;
 - (c) produce cash inflows or avoid cash outflows by, for example:
 - (i) using the economic resource either individually or in combination with other economic resources to produce goods or provide services;

(ii) using the economic resource to enhance the value of other economic resources; or

(iii) leasing the economic resource to another party;

(d) receive cash or other economic resources by selling the economic resource; or

(e) extinguish liabilities by transferring the economic resource.”

“4.20 An entity controls an economic resource if it has the present ability to direct the use of the economic resource and obtain the economic benefits that may flow from it. Control includes the present ability to prevent other parties from directing the use of the economic resource and from obtaining the economic benefits that may flow from it. It follows that, if one party controls an economic resource, no other party controls that resource.”

“4.26 A liability is a present obligation of the entity to transfer an economic resource as a result of past events.

4.27 For a liability to exist, three criteria must all be satisfied:

(a) the entity has an obligation (see paragraphs 4.28–4.35);

(b) the obligation is to transfer an economic resource (see paragraphs 4.36–4.41); and

(c) the obligation is a present obligation that exists as a result of past events (see paragraphs 4.42–4.47).

Obligation

4.28 The first criterion for a liability is that the entity has an obligation.

4.29 An obligation is a duty or responsibility that an entity has no practical ability to avoid. An obligation is always owed to another party (or parties). The other party (or parties) could be a person or another entity, a group of people or other entities, or society at large. It is not necessary to know the identity of the party (or parties) to whom the obligation is owed.”

“4.31 Many obligations are established by contract, legislation or similar means and are legally enforceable by the party (or parties) to whom they are owed. ...

4.32 In some situations, an entity’s duty or responsibility to transfer an economic resource is conditional on a particular future action that the entity itself may take. Such actions could include operating a particular business or operating in a particular market on a specified future date, or exercising particular options within a contract. In such situations, the entity has an obligation if it has no practical ability to avoid taking that action.”

“4.68 Income is increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.”

13. The Committee notes that in the extant case:

- The collateral is not received from the Member Banks in their capacity of a shareholder and the collateral received is akin to refundable security deposit from a customer. The SGF contribution is refundable to a Member Bank if there is excess collateral fund contributed by it or in case the Member Bank decides to off-board. This obligation of refunding the contribution arises from the policy approved by the RBI pursuant to PSS Act, 2007.
- The definition of liability, read together with the definition of economic resource, requires existence of an obligation that has the potential to require an entity to transfer economic benefits. There are two aspects of the definition that merit attention – (a) The first criterion for a liability is that the entity has an obligation i.e. there is a duty or responsibility that an entity has no practical ability to avoid and (b) For the potential of transfer of economic benefits to exist, it does not need to be certain that when the obligation will result in outflow of economic benefits. It is only necessary that at least in some circumstances, it would result in outflow of economic benefits.
- An obligation is not negated merely because of a lack of funds, statutory restrictions or insufficient profits or reserves or that it is conditional on a particular future action. The focus is on whether the entity has the practical ability to avoid a transfer of economic resources - neither management's intention nor the likelihood of a transfer affects the practical ability assessment.

From the above, the Committee notes that in the extant case, compliance with the RBI approved policy casts an obligation on the Company to refund the funds to a Member Bank in specified situations – an obligation which the Company has no practical ability to avoid even though this refund may be in limited situations, or the likelihood of such refund is low. Accordingly, it is appropriate for the Company to recognise SGF contributions received from Member Banks as a 'liability'.

14. Further, in the context of recognition of collateral received from Member Banks and investments made therefrom as 'asset', the Committee notes the following:

- The sum of money paid by a Member Bank to the Company goes out of the control of such Member Bank during the period it is held as contribution by the Company. The contributing Member Bank cannot use it for any purpose and therefore, no further economic benefit accrues to the Member from the holding of such sum by the Company. The Member is able to direct the use of the funds only if it exercises its right to get the refund i.e. if it decides to off-board.
- The Company has the obligation to ensure the settlement of transactions. The funds contributed by the Member Banks are only a source of funds available to the Company in fulfilling this obligation. The funds can be used by the Company interchangeably for meeting default by any Member Bank. In other words, the Company has the right to use the funds (though for restricted purposes) to meet its obligations.
- All the operating and financing decisions pertaining to those funds/investments are taken by the Corporation at its discretion, such as, all investment decisions as to

when, where and how to invest the funds, selling those investments and utilisation of the proceeds, when and how to meet any contingency arising due to failure of a Member Bank in fulfilling its obligation of settlement, etc. (though this is subject to the broader requirements of the policy). It has the free access to the funds/assets and can also prevent others from the access of these funds/assets.

- Income from investments or interest on cash held accrues to the Company and is to be used to meet the cost of servicing the LoC and settlement obligations of the Company.

Overall, in the extant case, the Company exercises control over the funds and is entitled to income earned on the funds during the period the funds are held by it.

Accordingly, it is appropriate for the Company to recognise amounts invested from SGF contributions in fixed deposits as 'assets' in the financial statements. However, since the SGF balance held by the Company as well as the related amount in the form of cash/investments are restricted in nature and can only be used for specified purposes, the Committee is of the view that the financial statements should include an explanatory note regarding the balances being restricted.

D. Opinion

15. On the basis of the above and subject to paragraph 10 above, the Committee is of the following opinion on the issues raised in paragraph 9 above:

- (a) The Company has control over the funds received towards SGF contribution from Member Banks for the period the funds are held by it and the investments made with such funds. However, there is also an obligation to repay the funds to the Member Banks as per the policy. Accordingly, it is appropriate for the Company to recognise SGF contribution received from Member Banks as a 'liability and amounts invested from such contributions as 'assets' in the financial statements, as discussed in paragraphs 13 and 14 above. However, since the SGF balance held by the Company as well the related amount in the form of cash/investments are restricted in nature and can only be used for specified purposes, the financial statements should include an explanatory note regarding the balances being restricted.
- (b), (c) and (d) In view of (a) above, answers to these questions do not arise.
