

## REGULATION OF OFF- BALANCE SHEET ACTIVITIES OF BANKS

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## REGULATION OF OFF- BALANCE SHEET ACTIVITIES OF BANKS

### INTRODUCTION

**1.1** A wide array of work streams which have examined the causes and effects of the recent global financial crisis have identified the effective regulation and supervision of large and complex financial institutions (LCFIs) as one of the areas where the policy measures should concentrate so as to avoid and mitigate the impact of a systemic crises in future. Banking regulators across the globe have been particularly concerned about the role played by the Private Pools of Capital (PPCs) and the off-balance sheet vehicles established by banks, in spreading and aggravating the impact of the crisis. The G20 Working Group on Enhancing Sound Regulation and Strengthening Transparency has *inter alia* recommended that the LCFIs require particularly robust oversight given their systemic importance, which arises in part from their size and inter connectedness (or correlation) with other institutions, and from their influence on markets,

**1.2** The G-30 Report on 'Financial Reform – A Framework for Financial Stability' released on January 15, 2009, observed that large, systemically important banking institutions should be restricted in undertaking proprietary activities that present particularly high risks and serious conflicts of interest. Sponsorship and management of commingled private pools of capital (that is, hedge and private equity funds in which the banking institutions own capital is commingled with client funds) should ordinarily be prohibited and large proprietary trading should be limited by strict capital and liquidity requirements.

**1.3** Both IASB and FSAB have intensified their efforts to strengthen the accounting standards relating to consolidation of special purpose entities set up for securitization with the sponsoring institutions and de-recognition and disclosure of transferred assets.

**1.4** Of late, Indian banks have shown increased interest in sponsoring and managing private pools of capital such as venture capital funds and infrastructure funds. Therefore, there is need for banks to have greater awareness of the risks inherent in such activities and limit such exposures commensurate with their risk management and available capital. Keeping in view the reputational risk involved in such activities, the Reserve Bank had mandated maintenance of certain level of economic capital in some of the cases approved in the recent past. However, in view of the wider implication of regulatory policy stance of RBI on this aspect, in the Annual Policy Statement for 2009-10, it was proposed to issue a paper on prudential issues in banks' floating and managing private pools of capital for eliciting public comments which will form the basis for finalising regulatory guidelines by September 30, 2009.

**1.5** The issue of formulation of regulations for possible consolidation of securitization SPVs with the sponsored banks has been engaging attention of RBI ever since guidelines on securitization of assets by banks were issued in February 2006. The recent crisis and consequent international activity to strengthen the accounting and regulatory framework in this regard have prompted RBI to accelerate the formulation of regulatory guidelines in this regard.

**1.6** In the above background, this Discussion Paper examines various issues relevant in the context of banks' significant involvement with the Mutual Funds (MFs), Venture Capital Funds (VCFs), Private Equity Funds (PEFs) and SPVs (*hereinafter collectively referred to as 'sponsored entities'*), both as sponsors and investors, adequacy or otherwise of existing regulatory framework and Indian accounting standards to address the concerns and suggests feasible regulatory and prudential options to limit the risks inherent in such activities.

## **2. EXISTING RBI GUIDELINES ON BANKS' INVOLVEMENT IN 'SPONSORED ENTITIES'**

### **2.1 Investment in MFs/VCFs/PEFs**

**2.1.1** Exposure of banks to VCFs is reckoned for compliance with the regulatory ceiling of 20% of networth for direct investment in equity.

**2.1.2** Investment in shares/units of VCFs is assigned a risk weight of 150% for measuring credit risk during first three years when these are held under HTM category. Same way investments in bonds of VCFs will attract a risk weight of 150% till these are held under HTM for the first three years. Exposure to VCFs in any form other than investment will also carry a risk weight of 150%. The specific risk capital charge for VCF investments classified as AFS has been fixed at 13.5%.

**2.1.3** Investment by a bank in a subsidiary company, financial services company, financial institution, stock and other exchanges should not exceed 10 per cent of the bank's paid-up capital and reserves and the investments in all such companies, financial institutions, stock and other exchanges put together should not exceed 20 per cent of the bank's paid-up capital and reserves. Banks cannot, however, participate in the equity of financial services ventures including stock exchanges, depositories, etc. without obtaining the prior specific approval of the Reserve Bank of India notwithstanding the fact that such investments may be within the ceiling prescribed under Section 19(2) of the Banking Regulation Act.

### **2.2. Securitisation of assets**

In the case of securitization, as per RBI Guidelines, if the following criteria for 'true sale' are met, the assets are deemed to have been derecognized from the books of the originator:

- I. The sale should result in immediate legal separation of the originator from the assets which are sold to the new owner viz. the SPV. The assets should stand completely isolated from the originator, after its transfer to the SPV, i.e., put beyond the originator's as well as their creditors' reach, even in the event of bankruptcy of the originator.

- II. The originator should effectively transfer all risks/ rewards and rights/ obligations pertaining to the asset and shall not hold any beneficial interest in the asset after its sale to the SPV. An agreement entitling the originator to any surplus income on the securitised assets at the end of the life of the securities issued by the SPV would not be deemed as a violation of the true sale criteria. The SPV should obtain the unfettered right to pledge, sell, transfer or exchange or otherwise dispose of the assets free of any restraining condition.
- III. The originator shall not have any economic interest in the assets after its sale and the SPV shall have no recourse to the originator for any expenses or losses except those specifically permitted under these guidelines.
- IV. There shall be no obligation on the originator to re-purchase or fund the re-payment of the asset or any part of it or substitute assets held by SPV or provide additional assets to the SPV at any time except those arising out of breach of warranties or representations made at the time of sale. The originator should be able to demonstrate that a notice to this effect has been given to the SPV and that the SPV has acknowledged the absence of such obligation.
- V. An option to repurchase fully performing assets at the end of the securitisation scheme where residual value of such assets has, in aggregate, fallen to less than 10% of the original amount sold to the SPV ('clean up calls') as allowed vide paragraph 10 can be retained by the originator.
- VI. The originator should be able to demonstrate that it has taken all reasonable precautions to ensure that it is not obliged, nor will feel impelled, to support any losses suffered by the scheme or investors.
- VII. The sale shall be only on cash basis and the consideration shall be received not later than at the time of transfer of assets to the SPV. The sale consideration should be market-based and arrived at in a transparent manner on an arm's length basis.

- VIII. Provision of certain services (such as credit enhancement, liquidity facility, underwriting, asset-servicing, etc.) and assumption of consequent risks/ obligations by the originators as specifically allowed in these guidelines would not detract from the 'true sale' nature of the transaction, provided such service obligations do not entail any residual credit risk on the assets securitized or any additional liability for them beyond the contractual performance obligations in respect of such services.
- IX. An opinion from the originating bank's Legal Counsel should be kept on record signifying that: (i) all rights, titles, interests and benefits in the assets have been transferred to SPV; (ii) originator is not liable to investors in any way with regard to these assets other than liability for certain permitted contractual obligations for example, credit enhancement/ liquidity facility; and (iii) creditors of the originator do not have any right in any way with regard to these assets even in case of bankruptcy of the originator.
- X. Any re-schedulement, restructuring or re-negotiation of the terms of the underlying agreement/s effected after the transfer of assets to the SPV, shall be binding on the SPV and not on the originator and shall be done only with the express consent of the investors, providers of credit enhancement and other service providers. This should be expressly provided in the sale transaction documents.
- XI. The transfer of assets from originator must not contravene the terms and conditions of any underlying agreement governing the assets and all necessary consents from obligors (including from third parties, where necessary) should have been obtained.
- XII. In case the originator also provides servicing of assets after securitisation, under an agreement with the SPV, and the payments/repayments from the borrowers are routed through it, it shall be under no obligation to remit funds to the SPV/investors unless and until these are received from the borrowers.
- XIII. The originator should not be under any obligation to purchase the securities issued by the SPV and should not subscribe to their primary issue. The originator may, however, purchase at market price only senior securities issued by the SPV

if these are at least 'investment grade', for investment purposes. Such purchase, along with the securities that may devolve on account of underwriting commitments, should not exceed 10% of the original amount of the issue.

- XIV. The originator shall not indulge in market-making or dealing in the securities issued by the SPV.
  
- XV. The securities issued by the SPV shall not have any put options. The securities may have a call option to address the pre-payment risk on the underlying assets.

### **2.3 Applicability of Capital Adequacy Norms at Group Level**

**2.3.1** The major supervisory concern from the perspective of capital adequacy is to prevent 'double gearing' of capital within the group. At present, the capital adequacy of all commercial banks is assessed in accordance with the New Capital Adequacy Framework (Basel-II), which is applicable at the solo level (including overseas operations) as well as at the consolidated level. For this purpose, a consolidated bank is defined as a group of entities where a licensed bank is the controlling entity. A consolidated bank will include all group entities under its control, except the exempted entities which include group companies which are engaged in insurance business and businesses not pertaining to financial services.

**2.3.2** So far as the bank's investments in the subsidiaries (including in equity and other capital instruments) are concerned, these are off-set against the bank's equity while preparing the consolidated accounts as per AS-24. Thus, the process ensures that the capital resources are reckoned only once in the entire group. In the case of entities which are not consolidated as per accounting standards in order to prevent the multiple use of the same capital resources in different parts of the group, the investments are deducted from the capital of the consolidated bank 50 per cent each from Tier 1 and Tier 2 capital. In case of any shortfall in the regulatory capital requirements in the non-consolidated entity, the shortfall shall be fully deducted at 50% from Tier 1 capital and 50% from Tier 2 capital.

**2.3.3** Investments upto 30% of the equity of the investee company are treated as non-significant from the perspective of control and therefore are treated like any other investment of the bank for the purpose of capital adequacy.

**2.3.4** In the case of entities in which the bank has equity investment between 30% and 50% of the total equity of the investee company, in order to prevent the multiple use of the same capital resources in different parts of the group, the investments are deducted from the capital of the consolidated bank 50 per cent each from Tier 1 and Tier 2 capital.

**2.3.5** For the purpose of assessing regulatory capital of the consolidated bank, the minority interests that arise from consolidation of less than wholly owned banks, securities or other financial entities in consolidated capital, can be recognized to the extent these are within the regulatory minimum capital for that entity.

**2.3.6** Upstreaming of capital: The investments made by a banking subsidiary/associate in the equity or non equity regulatory-capital instruments issued by its parent bank, should be deducted from such subsidiary's regulatory capital at 50 per cent each from Tier 1 and Tier 2 capital, in its capital adequacy assessment on a solo basis (50 per cent each from Tier 1 and Tier 2 capital).

## **2.4 Supervisory Framework for Banking Groups**

### **2.4.1 Guidelines for Consolidated Accounting and other quantitative methods to facilitate Consolidated Supervision**

(i) At present, consolidated supervision would be mandated for all groups where the controlling entity is a bank. In due course, banks in mixed conglomerates would be brought under consolidated supervision, where:

- a. the parents may be non-financial entities, or
- b. the parents may be financial entities falling under the jurisdiction of other regulators like Insurance Regulatory and Development Authority or Securities and Exchange Board of India, or



- c. the supervised institution may not constitute a substantial or significant part of the group.
- (ii) The components of consolidated supervision as proposed to be implemented by the RBI include:
  - a) Consolidated Financial Statements [\[CFS\]](#), which are intended for public disclosure.
  - b) Consolidated Prudential Reports [\[CPR\]](#) for supervisory assessment of risks which may be transmitted to banks (or other supervised entities) by other group members.
  - c) Application of certain prudential regulations like capital adequacy, large exposures / risk concentration etc. on group basis.

#### **2.4.2 Definition of Group**

Presently, the 'Group' is defined as an arrangement involving two or more entities related to each other through any of the following relationships and a 'Group entity' as any entity involved in this arrangement as indicated below:

- a) Subsidiary – parent (defined in terms of AS 21),
- b) Associate (defined in terms of AS 23),
- c) Joint venture (defined in terms of AS 27),
- d) Promoter-promotee,
- e) A related party (defined in terms of AS 18),
- f) Common brand name, and investment in equity shares 20% and above.

While the broking arms and housing finance companies belonging to the identified groups are included within the Group, Regional Rural Banks, Depositories, Asset Reconstruction Companies and Associates of SBI have been kept out from the purview of the above definition

### 2.4.3 Definition of a Financial Conglomerate (FC)

An FC is defined as a cluster of companies belonging to a Group which has significant presence in at least two financial market segments out of *banking business, insurance business, Mutual Fund business and NBFC business* (deposit taking and non-deposit taking). The significant presence in each of the market segments is defined as under:

Financial market segment	Threshold for significant presence
Banking business	Included in the top 70% of the segment in terms of asset base
Insurance business	Turnover more than Rs.100 crore
Mutual Fund business	Included in the top 70% of the segment in terms of asset under management (AUM)
NBFC (deposit taking)	Included in the top 70% of the segment in terms of deposit base
NBFC (non-deposit taking)	Asset base more than Rs.2000 crore

### 3. RELEVANCE OF ACCOUNTING RULES FOR CONSOLIDATION AND CONSOLIDATED SUPERVISION OF BANKS

Basel-II Framework is applicable at the level of banking groups. If an entity affiliated to a bank qualifies for consolidation with it as per the applicable accounting standards, no specific measures need to be taken by the banking supervisors as the capital adequacy in respect of assets of the affiliated entities is automatically taken care of. However, if any affiliated entity escapes accounting consolidation, and supervisors feel that the assets of such entities need to be taken into consideration while assessing the capital adequacy of banking groups, such entities are notionally consolidated with the banks for the purpose of capital adequacy and also for other purposes such exposure norms and risk management. Such consolidation for regulatory purposes will not involve consolidation of asset and liabilities and P&L of the relevant entities with that of the

bank. This consolidation would essentially mean taking into consideration the assets, exposures, risks of these entities while assessing capital adequacy, applying exposure norms and monitoring of various risk parameters at the group level. Application of capital adequacy at the group level is based on the premise that knocking-off of capital investment in the consolidated entity, from the capital of the sponsor in the process of consolidation is not sufficient given the historical evidence that banks do bail out their subsidiaries in the time of distress and, thus, absorb losses in excess of their equity investments. Thus, this approach indirectly takes into account reputational risk in respect of subsidiaries in computation of regulatory capital.

The changes effected or proposed to be effected as indicated in para 2 above by IASB and FSAB have implications for banks functioning in the jurisdictions where these standards are applicable. So far as banks operating in India are concerned, these standards would not be applicable unless ICAI amends the corresponding standards. While ICAI may in due course carry out the necessary changes in Indian Accounting standards, in view of the high importance of such changes for internationally active banks, it would be necessary for us to issue some guidance to our banks in the matter concurrently.

One common aspect of all these new accounting standards is that they are not exclusively designed for banks. Since these lay down common principles, respective regulators may add some modifications to them while advising banks to follow the same. For instance, Federal Reserve System in its Press Release of June 12, 2009 has advised the banks to follow FAS 166 and 167, until corresponding guidelines are issued by FED to them. Other common features of these standards are their primary focus on clarification of rules relating to possible consolidation of SPVs and convergence of related provisions contained in IASB Standards and FSAB Statements.

So far as Indian banks are concerned, we may incorporate the provisions of these standards in our proposed Discussion Paper suitably and may amend them based on public comments as also the final versions of these standards/regulatory guidelines.

#### **4. INDIAN ACCOUNTING STANDARDS**

**4.1** As per AS-21, subsidiaries are required to be consolidated by parents. A subsidiary is defined as “an enterprise that is controlled by another enterprise (known as the parent).”

**4.2** Indian accounting standards, define control only in terms of equity holding and voting power and therefore cannot address other possible grounds for consolidation such as those contained in existing IASB standards for consolidation, IAS-27 and SIC-12 and the Exposure Draft – 10 issued for comments in March 2009. Indian Accounting standards are also not designed to evaluate possible consolidation of securitization SPVs mainly for the reason that these are based only on equity stake and voting power which are not relevant for consolidation of securitization SPVs. Indian accounting standards are also not designed to consolidate non-corporate entities such as partnership forms, trusts, funds set up by the parents.

**4.3** Though provisions of AS-30 in relating to de-recognition of transferred assets/securitized assets are similar to that contained in IAS-39, these would have to be amended in the light of changes being proposed in IAS-39 by IASB.

#### **5. ISSUES IN BANKS’ EXPANSION INTO OFF-BALANCE SHEET ACTIVITIES**

Issues relating to and proposed regulatory framework for banks’ involvement in sponsoring of investment in PPCs are discussed in **Appendix A**. Issues relating to and proposed regulatory framework for possible consolidation of Securitisation SPVs are discussed in **Appendix B**. These appendices *inter alia* contain summaries of the Exposure Drafts (ED-10 and 2009/03 issued by IASB and FAS 166 and 167 issued by

FASB which are the main outcome of the current international efforts in the area of strengthening of the accounting framework for consolidation of bank-sponsored entities and the de-recognition of transferred assets, in the wake of the financial crisis.

**5.1** A summary of issues discussed in **Appendix A** is given below:

**5.1.1** Private pools of capital (PPC) bring significant benefits to the financial markets and provide an alternative asset class with the potential for superior returns and portfolio diversification. Banks and other financial institutions get involved with PPCs as sponsors, managers, investors, lenders and counterparties to various transactions with them. In view of the rapid growth, both in terms of volume and systemic importance of PPCs, the issue of regulation and supervision thereof has been engaging attention of the policy makers all over the world for a few years. The “Group of 30” – an international committee of current and former senior regulators and bankers – released 18 recommendations for reform of financial market oversight in October 2008<sup>1</sup>. The Group, inter alia, recommended that large, systemically important banking institutions should be restricted in undertaking proprietary activities that present particularly high risks and serious conflicts of interest. Sponsorship and management of commingled private pools of capital (that is, hedge and private equity funds in which the banking institutions own capital is commingled with client funds) should ordinarily be prohibited and large proprietary trading should be limited by strict capital and liquidity requirements. Another recommendation titled “Oversight of Private Pools of Capital” and calls for registration and regulation of managers of leveraged investment pools. Though in India, we caught up with the trend late but the momentum, Indian banks have shown greater interest in expansion into different types of non-banking financial activities as part of their growth strategies. Their interactions with the PPCs have increased due both to their increased overseas presence and growth of PPCs especially the VCFs in India. Considering these developments, it is felt necessary to stimulate public debate in the country regarding the Indian banks’ growing involvement with PPCs.

**5.1.2** The advantages of sponsoring and investing in PEFs include diversification benefits, and higher returns. Super-normal profits are expected to arise from information arbitrage opportunities that result from the market's immaturity, and hence relative inefficiency. From the specific standpoint of banks, it has been noticed that banks are increasingly becoming keen to float PEFs/VCFs funds in order to add to their non-interest income. This gives them the opportunity to exploit their expertise in risk management and advisory services as some banks have already been into wealth management. Compared to a third-party fund, banks have a significant advantage for sourcing investment through their network. A lot of standalone PE funds have a presence only in some cities. But banks can use their network at their advantage. Not only investment but also the target companies also may come to the notice of the bank because of their huge client base.

**5.1.3** On the flip side, the sponsors of and anchor investors in the PPCs are exposed to significant on-balance sheet and off-balance sheet (reputational risks) items. These include the generic risks which are faced by any institutional investor or sponsor of PEFs and also the specific risks which are faced by banking organisations sponsoring and investing in PEFs. The generic risks in hedge PEF investments are the inherently risky nature of such investments due to high uncertainty of successful completion of projects, risks involved in LBO financing, conflicts of interest from the perspective of management of PEF acquired firms who may be promised unrealistic returns by the PEF firm so as to elicit their support putting the shareholders to disadvantage. Further, corporate Governance, in the recent time has hogged much lime light in respect of Private Equity firms, Portfolio firms and interrelation between these two. Reputational risks concerning PEFs arise from regulatory action against PEFs, loss of investor faith in case of failure especially where investors are socially sensitive entities such as pension funds, criticism from job losers as a result of take-overs and negative media perception.

**5.1.4** Banking organizations engaging in private equity activities face special compliance challenges compared with their nonbanking competitors. All over the world banks' expansion into other financial and non-financial activities is tightly regulated and restricted due to inherent fragile nature of banking organisations due to high leverage and high degree of sensitivity to reputational risks. The reputation of the banks can act as a double edged sword in the PE deals. If everything goes well then there will be no threat to reputational risk. But given the very uncertain nature of these deals the chances of success are never known. If a deal fails then 'word of mouth' bad publicity can do tremendous harm to the reputation of the bank. As this is just one of the businesses of the bank and not the main business like other PE houses, the reputational risk poses much threat to the bank than other counterparts floating PE funds. The core business of the bank may seriously get affected because of these. While restrictions on the overall share of a financial conglomerate in non-banking business can effectively limit the financial losses to banks arising from such activities, the aggregate limits are not effective in controlling the reputational risks. This is so because even the financial/operational failure of one or two subsidiaries of banks are enough to tarnish its reputation. A bank having significant stake (say more than 20%) in a particular PEF may suffer reputational loss, in addition to the financial loss, even if the Fund is not being managed by one of the AMCs which are subsidiaries/associates of the bank. Banks lend to PEFs to finance the leveraged buyouts. While in India, the existing RBI regulations prohibit lending for mergers and acquisitions, internationally banks have engaged in a big way in financing LBOs undertaken by PEFs. LBO financing is a highly risky finance.

**5.1.5** Intense LBO activity has been identified with a number of potential systemic risks and vulnerabilities that could arise from banks' involvement in the private equity market, in particular their facilitation of leveraged buyout transactions. In recent years, improvement in the financial positions of non-financial firms throughout the European Union – against the backdrop of low interest rates, ample liquidity and consolidation of economic growth – has supported the expansion of M&A activity in the region. These developments have led to intensifying competition among investors and financing

providers in the LBO market. Although banks which are active in the EU market asserted that careful credit analysis was consistently carried out in LBO transactions, it could not be excluded that such pressures could encourage banks to compromise their due diligence and loosen their credit standards should the rapid growth in the market continue. This survey identified the key risk for individual banks as being caught with a large exposure (for example, a bridge loan) when an LBO deal fails prior to distribution. Failed syndication may leave the bank with very large and concentrated exposures to individual names that it was not intending to hold beyond the short run. In such cases the originating bank could become exposed to a potentially very large credit loss and, via expectations, broader market confidence could be hit. The role of failed syndications or prolonged syndication times as a key indicator of potential problems in the LBO market is further enhanced by the dilution of the role of loan covenants as early warning indicators.

**5.1.6** With the increased focus on preventing the non-consolidation of entities sponsored by banks where banks seem to be committing implicit support out of reputational concerns, both IASB and FASB are actively engaged in modifying the existing accounting standards relating to consolidation of entities. IASB has issued an Exposure Draft on Consolidation (ED-10). ED-10, seeks to re-define and bring to more focus the aspect of 'control' as a basis for consolidation. In addition, in view of the recent financial crisis, it also initiates a debate on whether 'reputational risk' could be a basis for consolidation. While the provisions relating to consolidation of Mutual Funds and PEFs in ED-10 are not very clear, it is expected that more clarity would emerge in the final version. As per the ED, there is possibility that in some cases MFs/VCFs/PEFs may be deemed to be controlling the investee companies which may have to be consolidated with them. It appears that the investors in the MFs/VCFs/PEFs may be required to consolidate the investments in these entities, if they meet the definition of control. As per para 28 of the IFRS, a reporting entity can have the power to direct the activities of another entity if the reporting entity is the dominant shareholder that holds voting rights and all the other shareholders with voting rights are widely dispersed and are not organised in such a way that they actively co-operate when they exercise their



votes so as to have more voting power than the reporting entity. Thus, in cases where the sponsoring institution has a controlling interest in the AMC of the MF/PEF, and also is the dominant shareholder in the MF/PEF, it may be possible to argue for consolidation of such a fund with the sponsoring institution.

**5.2** A summary of issues discussed in **Appendix B** is given below:

**5.2.1** Consequent upon failure of Enron, in December 2003, FASB brought in concept of Qualifying SPV through an accounting standard *Consolidation of Variable Interest Entities*, {(FIN 46 (R))} as per which unless SPV met the conditions for a Qualifying SPV it had to be consolidated. These rules focused on recognizing the significant residual risks by the sponsors of SPVs/SPEs, extending the scope of recognition beyond the usual measures of voting rights and equity investments. In 1998, IASB also issued SIC-12, to achieve similar objectives. However, the sub-prime crisis established beyond doubt that the above accounting provisions are insufficient to capture all the residual risks retained by the sponsors. More particularly, it was found that many SPEs/SIVs sponsored by the banks had to be provided liquidity support, even though the existing accounting rules did not explicitly require consolidation of these SIVs by the banks. Thus, the risks carried by the SPVs escaped recognition in the group level balance sheets of banks concerned. The on-going efforts at the IASB and FSAB are aimed at improving the existing accounting norms in this regard.

**5.2.2** Under IFRS, an SPE is consolidated when the substance of the relationship between the sponsor and the SPE indicates that the SPE is controlled by the sponsor. SIC-12 governs this assessment under IFRS. The substance of the relationship between the sponsor and the SPE is determined based on whether the activities of the SPE are being conducted on behalf of the sponsor according to its specific business needs, so that the sponsor obtains benefits from the SPE's operation; whether the sponsor has the decision-making power to obtain the majority of the benefits of the

activities of the SPE or, by setting up an 'autopilot' mechanism, the sponsor has delegated these decision-making powers; whether the sponsor has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or whether the sponsor retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

**5.2.3** ED 10, referred to earlier in this Discussion Paper lays down specific rules regarding consolidations of structured entities. As per ED-10, when assessing control of a structured entity, it is necessary to identify how returns from the entity's activities are shared and how decisions, if any, are made about the activities that affect those returns. A reporting entity shall consider all relevant facts and circumstances, including the purpose and design of the structured entity; the reporting entity's returns from its involvement with the structured entity, the activities of the structured entity, including the extent to which the strategic operating and financing policies that direct those activities have been predetermined; related arrangements; the reporting entity's ability to change the restrictions or predetermined strategic operating and financing policies; and whether the reporting entity acts as an agent for other parties, or another party acts as its agent.

**5.2.4** In USA, the accounting rules regarding VIEs (SPVs) broadly fall in two categories: (i) Rules defining SPVs and possible consolidation thereof by the sponsors (ii) Rules regarding de-recognition of assets transferred to SPVs. The accounting rules for consolidation of SPVs with the sponsors are contained in applying FASB Interpretation No. 46 R (revised December 2003), *Consolidation of Variable Interest Entities*. The rules for de-recognition of assets are contained in FASB Statement No.140- *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. FASB has recently amended both FIN 46(R) and FAS 140 to strengthen the accounting rules for consolidation of SPVs and de-recognition of assets. In USA, SPVs are called as Variable Interest Entities.

Recently, FASB has amended FAS 140 and FIN 46 (R) through issuance of new accounting standards FAS 166 and FAS 167. FAS 166 removes the concept of a qualifying special-purpose entity from Statement 140 and removes the exception from applying FASB Interpretation No. 46 R (revised December 2003), *Consolidation of Variable Interest Entities*, to qualifying special-purpose entities. FAS -167 improves the definitional aspects of control of VIEs and introduces additional reconsideration events and re-assessment requirements.

**5.2.5** Sub-prime crisis has highlighted the need for strengthening the risk management aspects of SPVs by their sponsors/originators. At a minimum, the following measures could be taken by the originators to manage the risks associated with securitisation SPEs sponsored by them:

- (i) All parties to a securitisation transaction should be able to assess and have capability to manage the risk factors that increase transaction complexity
- (ii) Banks should ensure that the SPE has put in place governance process which is commensurate with the complexity of the structure.
- (iii) Banks should have the capability to monitor the performance of the SPVs sponsored by them and aggregate, assess and report all their SPE exposure risks, as part of their overall risk profile.
- (iv) If a sponsor is found to extending non-contractual support to an SPE, then the activities/assets of that SPE should be consolidated with those of the institution for both supervisory assessment and internal risk management purposes.

## **6. PROPOSED REGULATORY FRAMEWORK**

**6.1** The proposed regulatory framework for banks' involvement in sponsoring of and investment in PPCs and securitization SPVs is discussed in **Appendix C**. It is based on the recent initiatives taken by IASB and FSAB as discussed in **Appendices A and B**. In addition, it takes into account the renewed emphasis on recognition of reputational risk and implicit support laid by BCBS in the revised guidance entitled "Enhancement of Basel II Framework" (Pillar II)" which is reproduced below:

## **6.2 *Reputational risk and implicit support***

Reputational risk is the risk arising from negative perception on the part of customers, counterparties, shareholders, investors, debt-holders, market analysts, other relevant parties or regulators that can adversely affect a bank's ability to maintain existing, or establish new, business relationships and continued access to sources of funding (eg through the interbank or securitisation markets). Reputational risk is multidimensional and reflects the perception of other market participants. Furthermore, it exists throughout the organisation and exposure to reputational risk is essentially a function of the adequacy of the bank's internal risk management processes, as well as the manner and efficiency with which management responds to external influences on bank-related transactions.

Reputational risk can lead to the provision of implicit support, which may give rise to credit, liquidity, market and legal risk – all of which can have a negative impact on a bank's earnings, liquidity and capital position. A bank should identify potential sources of reputational risk to which it is exposed. These include the bank's business lines, liabilities, affiliated operations, off-balance sheet vehicles and the markets in which it operates. The risks that arise should be incorporated into the bank's risk management processes and appropriately addressed in its ICAAP and liquidity contingency plans.

Prior to the 2007 upheaval, many banks failed to recognise the reputational risk associated with their off-balance sheet vehicles. In stressed conditions some firms went beyond their contractual obligations to support their sponsored securitisations and off balance sheet vehicles. A bank should incorporate the exposures that could give rise to reputational risk into its assessments of whether the requirements under the securitisation framework have been met and the potential adverse impact of providing implicit support.

Reputational risk may arise, for example, from a bank's sponsorship of securitisation structures such as ABCP conduits and SIVs, as well as from the sale of credit exposures to securitisation trusts. It may also arise from a bank's involvement in asset or funds management, particularly when financial instruments are issued by owned or

sponsored entities and are distributed to the customers of the sponsoring bank. In the event that the instruments were not correctly priced or the main risk drivers not adequately disclosed, a sponsor may feel some responsibility to its customers, or be economically compelled, to cover any losses. Reputational risk also arises when a bank sponsors activities such as money market mutual funds, in-house hedge funds and real estate investment trusts. In these cases, a bank may decide to support the value of shares/units held by investors even though is not contractually required to provide the support.

The financial market crisis has provided several examples of banks providing financial support that exceeded their contractual obligations. In order to preserve their reputation, some banks felt compelled to provide liquidity support to their SIVs, which was beyond their contractual obligations. In other cases, banks purchased ABCP issued by vehicles they sponsored in order to maintain market liquidity. As a result, these banks assumed additional liquidity and credit risks, and also put pressure on capital ratios.

Reputational risk also may affect a bank's liabilities, since market confidence and a bank's ability to fund its business are closely related to its reputation. For instance, to avoid damaging its reputation, a bank may call its liabilities even though this might negatively affect its liquidity profile. This is particularly true for liabilities that are components of regulatory capital, such as hybrid/subordinated debt. In such cases, a bank's capital position is likely to suffer.

Bank management should have appropriate policies in place to identify sources of reputational risk when entering new markets, products or lines of activities. In addition, a bank's stress testing procedures should take account of reputational risk so management has a firm understanding of the consequences and second round effects of reputational risk.

Once a bank identifies potential exposures arising from reputational concerns, it should measure the amount of support it might have to provide (including implicit support of securitisations) or losses it might experience under adverse market conditions. In

particular, in order to avoid reputational damages and to maintain market confidence, a bank should develop methodologies to measure as precisely as possible the effect of reputational risk in terms of other risk types (eg credit, liquidity, market or operational risk) to which it may be exposed. This could be accomplished by including reputational risk scenarios in regular stress tests. For instance, non-contractual off-balance sheet exposures could be included in the stress tests to determine the effect on a bank's credit, market and liquidity risk profiles. Methodologies also could include comparing the actual amount of exposure carried on the balance sheet versus the maximum exposure amount held off-balance sheet, that is, the potential amount to which the bank could be exposed.

A bank should pay particular attention to the effects of reputational risk on its overall liquidity position, taking into account both possible increases in the asset side of the balance sheet and possible restrictions on funding, should the loss of reputation result in various counterparties' loss of confidence.

In contrast to contractual credit exposures, such as guarantees, implicit support is a more subtle form of exposure. Implicit support arises when a bank provides post-sale support to a securitisation transaction in excess of any contractual obligation. Implicit support may include any letter of comfort provided by the originator in respect of the present or future liabilities of the SPV. Such non-contractual support exposes a bank to the risk of loss, such as loss arising from deterioration in the credit quality of the securitisation's underlying assets.

By providing implicit support, a bank signals to the market that all of the risks inherent in the securitised assets are still held by the organisation and, in effect, had not been transferred. Since the risk arising from the potential provision of implicit support is not captured *ex ante* under Pillar 1, it must be considered as part of the Pillar 2 process. In addition, the processes for approving new products or strategic initiatives should consider the potential provision of implicit support and should be incorporated in a bank's ICAAP.

**6.3** While the Basel-II framework does not make a specific reference to the reputational risk arising from sponsoring of PPCs, it is not hard to draw the analogy between the two situations. While unlike securitisation SPVs, the PPCs do not create any residual risk for the banks in the sense that no assets are transferred from the bank to the PPC, the issues relating to reputational risk and implicit support are the same. The main issue in both cases is whether the bank would be obliged to support a distressed sponsored entity i.e. PPC or SPV. In the case of a PEF/VCF, bank would indirectly (through the AMC) get involved in management of real sector companies raising reputational/legal concerns in the event of failure of those companies. In addition, if the PEF/MF sponsored by the bank lose significantly, there is chance that the sponsoring bank would be obliged to lend them financial support in such a situation out of reputational concerns, and the support may eventually translate into absorption of losses exceeding the bank's own investment in the AMC and or the Fund.

**6.4** A summary of the major proposals is given below:

#### **6.4.1 Consolidation of PPPCs**

##### **6.4.1.1 Sponsoring and management of investment in PPCs**

Banks should normally not have a strategic interest in the AMCs managing the PPCs/Funds and the Fund itself. This can be ensured by not having controlling/significant interest in the AMCs/Funds. A bank will be deemed to be controlling an AMC/ Fund if it is deemed to be controlling the PEF or associated AMC. For this purpose, the controlling interest would be defined based on the provisions of ED-10 which, is based on the concept of power to direct activities of the subject entity. The power to direct the activities could be established either based on majority voting power, or focus on aspects such – (i) the bank has more voting rights than any other party; (ii) the bank's voting rights are sufficient to give the bank the ability to determine the AMC's strategic operating and financing policies;(iii) if the bank actually provides

non-contractual support below market rates out of reputational concerns when the AMC faces distress. In the case of bank's investment in a PEF/MF, the bank would be deemed to have controlling interest in the Fund if the bank's investment in the Fund exceeds 50% of its corpus.

A bank will be deemed to have a significant interest in the AMC/Fund if it has equity investment ranging from 20 to 50% (both figures inclusive) in the AMC or controls voting rights of the AMC from 20 to 50% (both figures inclusive) managing the Fund. Banks should normally not invest in excess of 50% of the corpus of a PPC. A bank will also be deemed to have significant interest in the Fund if its investment in the fund ranges between 20-50% of the corpus.

#### **6.4.1.2 Capital adequacy requirements**

In cases where a bank, or any of its subsidiaries/associates/joint ventures, or both bank and these entities together, intend to make an investment in AMC/Funds which would be deemed as a controlling or significant interest as defined above, it would be subject to the following minimum capital requirement on account of potential reputational risk for the bank are stipulated as under:

##### **(i) Capital Adequacy norms for banks' exposure to AMCs/Funds deemed as 'controlled' by the bank**

- a) A bank's direct investment in the AMC/Funds where the bank is deemed to have controlling interest will be deducted from its capital ( 50% from Tier I and 50% from Tier II capital)
- b) A bank will deemed to have a **high reputational risk** on account of its involvement with the Funds which are deemed as controlled by it in terms of above norms. The bank will, therefore, have to maintain capital treating the total assets of the Fund (net of its own investments) as its off-balance sheet exposure with a CCF of 50% and a risk weight of 100%.

##### **(ii) Capital adequacy norms for banks' investment in AMCs which are treated as 'significant interests'**



- a) A bank's direct investment in the AMC/Funds where the bank is deemed to have a significant interest will be deducted from its capital ( 50% from Tier I and 50% from Tier II capital)
- b) A bank will deemed to have **a significant reputational risk** on account of its involvement with the Funds where a bank holds significant interest in the AMC as defined above. The relevant exposure will be the equity investment in the Funds made by non-sponsor entities.
  - The exposure will be measured as an off-balance sheet exposure, as a portion of the AMC of the total outside liabilities of the Fund as computed at para (a) above, in proportion to the bank's stake in the AMC.
  - The exposure computed at para (b) above will be converted into a credit equivalent amount by applying a credit conversion factor of 20%.
  - The exposure computed at para (c) above, will be assigned a risk weight of 100%.
  - The RBI would reserve the right to periodically review this stipulation and scale up or down the capital requirement, if required.

**(iii) Capital Adequacy and Valuation Norms for Banks' Own Investments in the VCF/PEF other than that treated as controlling /significant interests**

- a) All such investments will be assigned a risk weight of 200% (specific capital charge of 18% in the case of investments held under AFS).
- b) In cases where the PEFs, as per their documented investment policies, are authorized to engage in LBOs, in view of higher risk caused by higher leverage involved in such transactions, the risk weight on the banks' investment in such PEFs will be 250% ( specific capital charge of 22.5%) in cases where the bank's investment in the PEF is within the limit of 20% indicated in para 1.1.1, and 300% ( specific capital charge of 27%) in other cases.

## **6.4.2 Sponsoring of Securitisation SPVs**

**6.4.2.1** When assessing control of a Special Purpose Vehicle/ Structured Entity, it is necessary to identify how returns from the entity's activities are shared and how decisions, if any, are made about the activities that affect those returns. A bank shall consider all relevant facts and circumstances, including the following:

- (a) the purpose and design of the structured entity
- (b) the reporting entity's returns from its involvement with the structured entity
- (c) the activities of the structured entity, including the extent to which the strategic operating and financing policies that direct those activities have been predetermined
- (d) related arrangements
- (e) the reporting entity's ability to change the restrictions or predetermined strategic operating and financing policies
- (f) whether the reporting entity acts as an agent for other parties, or another party acts as its agent

## **6.4.2.2 Proposed regulatory Framework for consolidation of SPVs**

- (i) If an SPV is determined to be controlled by the sponsored bank as per above rules, the bank will, for the purpose of capital adequacy norms, have to treat the securitized assets as if these were never securitized and the amount received as sale consideration as a secured borrowing. In all such cases, any on or off-balance sheet liabilities of the SPV to others will also be treated as liabilities of the bank.
- (ii) The investments held by the PPCs controlled by a bank and the assets of securitized SPVs deemed to be controlled by a bank will be reckoned for the purpose of single borrower/group of borrowers exposure norms.

- (iii) The assets and liabilities of the PPCs and SPVs controlled by a bank should be considered while assessing the credit concentration risks, liquidity risk, asset liability mismatches and interest rate risk in the banking book at the group level.

## **APPENDIX - A**

### **ISSUES IN BANKS' SPONSORING PRIVATE POOLS OF CAPITAL AND THE CURRENT INTERNATIONAL THINKING**

#### **Introduction**

1.1 Private pools of capital (PPC) bring significant benefits to the financial markets. For financial investors, investment in the PPC provides an alternative asset class with the potential for superior returns and portfolio diversification. At the macroeconomic level,

private equity allows capital to flow towards more viable projects and companies, and helps to finance new technologies, thus promoting employment and economic growth. Private equity including venture capital, and hedge funds are the principal forms of organized PPC. The survival of the private equity governance model depends on some economic advantages, described over public equity governance model. These potential advantages include, (i) the ability to change strategies of the private firm to generate higher returns, (ii) the ability to raise finance at favourable terms and (iii) better alignment of interests between shareholders of private equity firm and managers of the investee firms. However, these pools of capital also present challenges for market participants and policymakers. Investors, creditors, counterparties, pool managers, and supervisors must be aware of these challenges.

**1.2** Banks and other financial institutions get involved with PPCs as sponsors, managers, investors, lenders and counterparties to various transactions with them. Over the past few years until 2007, a combination of solid economic growth and low inflation contributed to sustain particularly benign global financial market conditions, characterised by low interest rates and low volatility. This environment set a worldwide search for yield in motion among large international banks, saving institutions and various types of investment funds. Either portfolio managers or institutional investors seeking to match their guaranteed return policies – have found equity investment in LBO funds attractive despite the inherently illiquid nature of such placements. More details of factors driving growth of private equity in the world are given in **Annex 1**.

**1.3** In view of the rapid growth, both in terms of volume and systemic importance of PPCs, the issue of regulation and supervision thereof has been engaging attention of the policy makers all over the world for a few years. The recent developments in the international financial markets especially the current credit crisis and the role played by the PPCs in these developments and the implications of the financial losses suffered by their sponsors including banks and other financial institutions have brought the debate regarding regulation and oversight of PPCs to the fore. A brief on international and domestic trends in the PEFs is given in **Annex 2**.

**1.4** In February 2007, The President's Working Group on Financial Markets (PWG) in USA<sup>ii</sup>, released a set of principles and guidelines to guide U.S. financial regulators as they address public policy issues associated with the rapid growth of private pools of capital, including hedge funds. The agreement among the PWG and U.S. agency principals, which would serve as a framework for evaluating market developments, specifically concentrates on investor protection and systemic risk concerns. The group has designed the principles to endure as financial markets continue to evolve. They provide a clear but flexible principles-based approach to address the issues presented by the growth and dynamism of these investment vehicles.

The principles are intended to reinforce the significant progress that has been made since the PWG last issued a report on hedge funds in 1999 and to encourage continued efforts along those same lines:

- **Private Pools of Capital:** maintain and enhance information, valuation, and risk management systems to provide market participants with accurate, sufficient, and timely information.
- **Investors:** consider the suitability of investments in a private pool in light of investment objectives, risk tolerances, and the principle of portfolio diversification.
- **Counterparties and Creditors:** commit sufficient resources to maintain and enhance risk management practices.
- **Regulators and Supervisors:** work together to communicate and use authority to ensure that supervisory expectations regarding counterparty risk management practices and market integrity are met.

**1.5** The “Group of 30” – an international committee of current and former senior regulators and bankers – released 18 recommendations for reform of financial market oversight in October 2008<sup>iii</sup>. The Group, inter alia, recommended that large, systemically important banking institutions should be restricted in undertaking proprietary activities

that present particularly high risks and serious conflicts of interest. Sponsorship and management of commingled private pools of capital (that is, hedge and private equity funds in which the banking institutions own capital is commingled with client funds) should ordinarily be prohibited and large proprietary trading should be limited by strict capital and liquidity requirements. Another recommendation titled "Oversight of Private Pools of Capital" and calls for registration and regulation of managers of leveraged investment pools.

**1.6** Though in India, we caught up with the trend late but the momentum that was seen in the Indian market is heart warming. As per KPMG survey<sup>iv</sup>, with a meagre five deals worth USD 20 million in 1996, PE activity grew to 339 deals worth USD 17.13 billion in 2007. So far as banks are concerned, the impact of the recent wave of financial innovations and inorganic corporate growth strategies adopted by international banks has also affected the Indian banks. During last few years Indian banks have shown greater interest in expansion into different types of non-banking financial activities as part of their growth strategies. Their interactions with the PPCs have increased due both to their increased overseas presence and growth of PPCs especially the VCFs in India.

**1.7** Considering these developments, it is felt necessary to stimulate public debate in the country regarding the Indian banks' growing involvement with PPCs. Indian Private equity market investments comprises mainly the venture capital and buy out investments. For the purpose of this paper a Private Equity Fund would mean a Fund which is engaged in the following three broad types of financial activities:

- (i) **Venture capital finance:** A seed stage, start-up stage and expansion stage unlisted investment ( including debt support) made by the PEF in the initial capital of a company at the time of implementation of the new/expansion project. It excludes any replacement finance/ secondary market purchase.
- (ii) **Buy outs:** Investment made in buyouts of existing companies, listed or unlisted. In the case of public-to-private transactions, the transaction should result in removal of the company from the stock exchange.

(iii) **Other private equity deals:** Any other unlisted equity/debt investments made which are not covered in (i) and (ii) above. E.g. Mezzanine finance provided in the form of subordinated debt and equity kickers in the context of LBO transactions; Financing of companies in need of restructuring or facing financial distress.

This appendix describes various issues regarding banks' existing or potential involvement with Private Equity Investments. The appendix does not address issues relating to hedge funds.

## **2. Pros and Cons of sponsoring and investing in PPCs**

### **2.1 Pros**

**2.1.1.** One benefit for PEFs arises from diversification. Due to their low correlation with traditional asset classes such as listed equity, property and fixed income, private equity investments can be used to diversify a bank's business lines by floating AMC's to manage PEFs or diversify the asset portfolios by making investments in the PEFs.

**2.1.2** Another key benefit of investing in private equity is the potential to earn higher returns than in the traditional asset classes, though this comes with higher risk and less liquidity. Super-normal profits are expected to arise from information arbitrage opportunities that result from the market's immaturity, and hence relative inefficiency. However, the strong growth in the size of the private equity market and the increase in the number of PE firms and investors in these markets may have led to the information asymmetry arbitrage being eroded.

**2.1.3** The hunt for yield in financial markets over recent years encouraged a wave of financial innovation, which created the new borrowing products and techniques but also made new LBO transactions more complex. LBO debt is now sliced into tranches and subsequently structured into products which cater to a wider range of risk appetites. As a result, borrowers can match debt much more closely to their anticipated cash flows and operate at a higher level of balance sheet efficiency and leverage. At the same time, these financial innovations allow investors to choose a tranche of a loan that more accurately reflects their risk appetite, allowing them to gain exposure to better risk return profiles than might otherwise have been available.

**2.1.4** From as specific standpoint of banks, it has been noticed that banks are increasingly becoming keen to float PEFs/VCFs funds in order to add to their non-interest income. This gives them the opportunity to exploit their expertise in risk management and advisory services as some banks have already been into wealth management. Compared to a third-party fund, banks have a significant advantage for sourcing investment through their network. A lot of standalone PE funds have a presence only in some cities. But banks can use their network at their advantage. Not only investment but also the target companies also may come to the notice of the bank because of their huge client base. The PE segment particularly fits into those banks' growth strategy which have a strong capital base. Banks have as special advantage in evaluation of companies for private equity finance as they earn their bread and butter by evaluating company whether it's creditworthy; they evaluate project proposals whether the project is viable etc. In case of a PE deal, if the bank is managing the fund (through its subsidiary) then the function of the bank remains essentially the same so far as it relates to evaluation of its creditworthiness or long term growth potential.

## **2.2 Cons**

The sponsors of and anchor investors in the PPCs are exposed to significant on-balance sheet and off-balance sheet (reputational risks) items. The generic risks which are faced by any institutional investor or sponsor of PEFs are described in **Annex 3**. Specific risks which are faced by banks sponsoring and investing in PEFs in addition to the generic risks, are discussed below.

### **2.2.1 Specific risk for banks in PE business**

The banks' risk characteristics in relation to PEF business/investments differ according to the nature of involvement.

#### **2.2.1.2 Banks as sponsors of PEFs**

While as a sponsor of a PEF a bank is exposed to all the risks described in the preceding section, these risks have more serious implications for banks as compared



with non-banking sponsors. All over the world banks' expansion into other financial and non-financial activities is tightly regulated and restricted due to inherent fragile nature of banking organisations due to high leverage and high degree of sensitivity to reputational risks. The reputation of the banks can act as a double edged sword in the PE deals. If everything goes well then there will be no threat to reputational risk. But given the very uncertain nature of these deals the chances of success are never known. If a deal fails then 'word of mouth' bad publicity can do tremendous harm to the reputation of the bank. As this is just one of the businesses of the bank and not the main business like other PE houses, the reputational risk poses much threat to the bank than other counterparts floating PE funds. The core business of the bank may seriously get affected because of these.

Main regulatory instruments used in this regard are limits on inorganic expansion into non-banking areas, restrictions on exposure to certain sectors, elaborate disclosures, limits on cross-holdings, restrictions on connected lending and regulations relating to constitutions of Boards of banks.

While restrictions on the overall share of a financial conglomerate in non-banking business can effectively limit the financial losses to banks arising from such activities, the aggregate limits are not effective in controlling the reputational risks. This is so because even the financial/operational failure of one or two subsidiaries of banks are enough to tarnish its reputation.

While some times an argument is made that generally the non-anchor investors in the PEFs are institutional or high networth individuals and they are capable of taking professionally-assisted decisions, and therefore, the regulators need not be concerned about the issues relating to investor protection. This philosophy has undergone change in the wake of recent developments in the financial markets and it is increasingly being felt that if a bank is one of the major partner in a PEF, it cannot escape the reputational risk as the general public does not know non-banks well and most of the institutional investors are fiduciaries (e.g pension funds, endowments) which hold investments in trust for individuals.

### **2.2.1.2 Banks as investors in PEFs**

A bank having significant stake (say more than 20%) in a particular PEF may suffer reputational loss, in addition to the financial loss, even if the Fund is not being managed by one of the AMCs which are subsidiaries/associates of the bank.

### **2.2.1.3 Banks as lenders to the PEFs**

Banks lend to PEFs to finance the leveraged buyouts. Banks' business model for LBO financing may be classified into two sub-categories: (i) Where participation in LBO transactions is mostly oriented towards raising fee income and a rapid distribution of credit exposures and thus in the nature of "capital turnover", an approach typically followed by investment banks; (ii) where banks tend to keep a significant share of exposures longer on their books and the banks' participation in the LBO market is motivated by fee but also interest income from holding the debt positions and thus is in the nature of "portfolio investment".

While in India, the existing RBI regulations prohibit lending for mergers and acquisitions, internationally banks have engaged in a big way in financing LBOs undertaken by PEFs. LBO financing is a highly risky finance. A consultative paper issued by Financial Services Authority, UK in 2007<sup>v</sup> notes that the amount of credit that lenders are willing to extend on private equity transactions has risen substantially. This lending may not, in some circumstances, be entirely prudent. Given current leverage levels and recent developments in the economic/credit cycle, the default of a large private equity backed company or a cluster of smaller private equity backed companies seems inevitable. This has negative implications for lenders (particularly before distribution), purchasers of the debt (particularly where these positions are concentrated or leveraged), orderly markets and conceivably, in extreme circumstances, financial stability of the economy. An analysis of various risks involved in financing of LBOs is given in **Annex 4**.

### **2.2.1.4 Risks to financial stability**

A survey entitled "Large banks and private equity-sponsored leveraged buyouts in the European Union" released in April 2007 by European Central Bank and other recent

related studies carried out by market observers and public authorities have identified a number of potential systemic risks and vulnerabilities that could arise from banks' involvement in the private equity market, in particular their facilitation of leveraged buyout transactions. The survey noted that in recent years, improvement in the financial positions of non-financial firms throughout the EU – against the backdrop of low interest rates, ample liquidity and consolidation of economic growth – has supported the expansion of M&A activity in the region. These developments have led to intensifying competition among investors and financing providers in the LBO market. In addition, the survey suggested a growth in fee-seeking behaviour among market participants. Although banks which are active in the EU market asserted that careful credit analysis was consistently carried out in LBO transactions, it could not be excluded that such pressures could encourage banks to compromise their due diligence and loosen their credit standards should the rapid growth in the market continue. This survey identified the key risk for individual banks as being caught with a large exposure (for example, a bridge loan) when an LBO deal fails prior to distribution. Failed syndication may leave the bank with very large and concentrated exposures to individual names that it was not intending to hold beyond the short run. In such cases the originating bank could become exposed to a potentially very large credit loss and, via expectations, broader market confidence could be hit. The role of failed syndications or prolonged syndication times as a key indicator of potential problems in the LBO market is further enhanced by the dilution of the role of loan covenants as early warning indicators. Indeed, the survey results suggested a growing tolerance for covenant breaches and a tendency towards fewer covenants being included at the outset in new deal contracts. The exposures that are retained by banks are typically located at the high end of the debt seniority spectrum and banks' recovery rates following any credit events are therefore likely to be higher than for the more junior creditors.

Banks' exposures to LBO activity are not limited to credit risk. The survey revealed that many banks are earning substantial income from the investment, fees and commissions derived from LBO-related activities. The opportunity to access such revenues had attracted new entrants to the market and encouraged existing players to expand their

activities. The growing reliance by some banks on fee and investment revenues from LBO financing suggested that any slowdown in the market could substantially hit these institutions' income streams. It was possible that several risks could crystallise at the same time. More aggressive deal financing structures could also be putting pressure on the future capacity of the target companies to repay the debt. Indeed, as highlighted in this survey, several banks report that the interest coverage of their LBO debt exposures was already rather low. Therefore, insofar as the debt was in variable interest rates, even a modest rise in interest rates could make debt servicing a challenge given the current cash-flow performance of lower-rated target companies in particular. Finally, although not directly derived from the survey, should the LBO cycle deteriorate in the foreseeable future, the outlook for distressed loan workout processes could be quite different for banks compared with previous LBO boom episodes. The involvement of a large number of debt investors who may be subject to different objectives and constraints may prevent the orderly workout processes typically associated with banks' relationship lending. Operational issues such as complex non-standard contractual terms and processes may complicate the assessment by investors of their positions in the seniority structure, and opaque risk transfer and risk management processes may obscure counterparties' true net debt exposures. The growing cross-border dimension of the EU market adds further complexities as several jurisdictions with different bankruptcy legislations may be involved in any given debt workout process. All these issues were likely to expose banks to new and unpredictable legal and reputational risks and it cannot be excluded that a clustering of legal disputes could cause temporary paralysis in the LBO market with potential spill-over effects to other markets, such as the derivatives markets. The survey recommended that to mitigate such risks, even when the probability of them crystallising is low, it is important that banks take frequent reviews of their exposure concentrations and borrowers' fundamental creditworthiness. Now, with the benefit of hindsight, it can be stated that the concerns highlighted by the survey were indeed very relevant.

### **3. Recent international efforts to manage risks in the sponsored entities**

Recent efforts regarding management of risks in the sponsored entities by banks mainly comprise the guidance issued by BCBS on enhancement of Basel II Framework and modifications to the accounting standards relating to consolidation. While the guidance of BCBS has been described earlier in the Discussion Paper, the main provisions of the new accounting standard - Exposure Draft – ED 2008/10 - Consolidation – issued by IASB and their implications for banks are summarized below.

### **3.1 Summary of Major Provisions of ED-10**

ED-10, seeks to re-define and bring to more focus the aspect of 'control' as a basis for consolidation. In addition, in view of the recent financial crisis, it also initiates a debate on whether 'reputational risk' could be a basis for consolidation. <sup>10</sup>Main common provisions of ED-10 in regard to consolidation are summarized below:

- Requires a reporting entity to consolidate the assets, liabilities, equity, revenues, and expenses of those entities it controls.
- Proposes a single definition of control for all entities, and provides guidance on how to apply that definition in particular situations that have been found difficult under the previous guidance. As a consequence, the International Accounting Standards Board (Board) expects that entities will be consolidated on a more consistent basis, making the financial statements of groups more comparable and understandable.
- Explains that a reporting entity controls another entity when it has the *power to direct* the activities of that other entity to *generate returns* for the reporting entity. The consequences of this are that only one party can control an entity and there could be circumstances in which the entity is not controlled by any party.
- Power can be gained in many ways, for example, by having voting rights, by having options or convertible instruments, by means of contractual arrangements, or a combination of these, or by acting as agent with the ability to direct the activities for the benefit of a controlling entity.
- Control conveys the right to obtain benefits (expressed in the proposal as "returns") from another entity. The concept of returns makes more explicit that a reporting entity may obtain positive or negative returns.
- Provides guidance to assist a reporting entity in determining whether it is considered to be in control of another entity.

- Proposes that a reporting entity assess the particular circumstances of its relationship with a structured entity when making a determination about its control. Factors to consider are the purpose and design of the structured entity and how decisions are made about activities that may cause the returns of the entity to vary.
- Since power can be difficult to assess when considering who controls a structured entity, the Board proposes a risks and rewards “fall back” test if power cannot be assessed. Under this approach a reporting entity would consolidate another entity if it is exposed to a particular level of variability of returns of a structured entity, without any requirement to have the power to direct the activities of that structured entity.
- Requires enhanced disclosure requirements for consolidated entities, particularly relating to the effect of non-controlling interests.

## **3.2 Specific Provisions of ED-10 relevant for banks**

### **3.2.1 Basis of Consolidation**

- (i) A reporting entity presents financial statements that consolidate its assets, liabilities, equity, income, expenses and cash flows with those of the entities that it controls.
- (ii) A reporting entity controls another entity when the reporting entity has the power to direct the activities of that other entity to generate returns for the reporting entity.
- (iii) Para 23-29 of the IFRS explain what is meant by power to direct control. A structured entity is an entity whose activities are restricted to the extent that those activities are not directed as described in paragraphs 23–29.

### **3.2.2 Implications of ED-10 for consolidation of/by MFs, VCFs, PEFs**

- i. In some cases MFs/VCFs/PEFs may be deemed to be controlling the investee companies which may have to be consolidated with them.
- ii. The standard clarifies that in general the AMCs of MFs/PEFs etc will be deemed to be agents of their principals (i.e investors) and will not be required to consolidate the assets under management with them. However, in some cases, where they themselves hold certain positions in the MFs/PEFs, there may be case for consolidation.
- iii. It appears that the investors in the MFs/VCFs/PEFs may be required to consolidate the investments in these entities, if they meet the definition of control. As per para 28 of the IFRS, a reporting entity can have the power to direct the activities of another entity if the reporting entity is the dominant shareholder that holds voting rights and all the other shareholders with voting rights are widely dispersed and are not organised in such a way that they actively co-operate when they exercise their votes so as to have more voting power than the reporting entity. Thus, in cases where the sponsoring institution has a controlling interest in the AMC of the MF/PEF, and also is the dominant shareholder in the MF/PEF, it may be possible to argue for consolidation of such a fund with the sponsoring institution.
- iv. Perusal of comments letters posted on the website of IASB revealed that many investment companies/Associations of MFs and PEFs have questioned the proposed rules which may require consolidation of the investee companies with the Funds and consolidation of Funds with the AMCs. In general they say that the rules are not sufficiently clear as to possible consolidation of Funds with the principles/investors. Most comment letters have requested for additional guidance in the matter. We may, therefore, expect some modifications and clarity in the final version of the IFRS.

#### **4. Appropriateness of Reputational Risk as a Basis of Consolidation**

4.1 As per para BC 36 of the Basis for Conclusions annexed to ED-10, Reputational risk refers to a reporting entity's implicit commitment to provide support to unconsolidated structured entities without having a contractual or constructive obligation to do so. However, it is equally applicable to all sponsored entities. ED-10 contains a specific question to be commented upon by the respondents in this regard. It reads as under:

##### **Question 11**

- (a) Do you think that reputational risk is an appropriate basis for consolidation? If so, please describe how it meets the definition of control and how such a basis of consolidation might work in practice.
- (b) Do you think that the proposed disclosures in paragraph B47 are sufficient? If not, how should they be enhanced?

4.2 Out of around 150 comments letters posted in the website of IASB, most have supported the IASB conclusion that reputational risk is not an appropriate basis for consolidation. Some respondents have highlighted the need for including evaluation of 'reputational risk' as one of the criteria for evaluating control, although it may not form a basis for consolidation on its own. The main reason for such an approach is that the whole ED-10 is based on objective evidence of 'control model' and it is not possible to say ex-ante whether and in what circumstances the sponsoring entity would render support to justify the existence of control.

4.3 ED-10 gives the following reasons for not basing the consolidation on reputational risk:

4.3.1 The Board observed that some financial institutions have recently acquired financial interests in structured entities to provide funding that those entities could not obtain from third parties because of the lack of liquidity in the market. Those financial institutions had previously acted as sponsors when structuring those



entities. They stated that there was no legal obligation for them to acquire the financial interests. The Board observed that before those transactions the financial institutions that were exposed to reputational risk did not control those structured entities. The Board concluded that the consolidation of structured entities on the basis of reputational risk is inconsistent with the controlling entity model( which is the primary basis of ED-10).

4.3.2 The Board investigated also whether it should use reputational risk as a separate basis for consolidation in addition to control. However, the Board was concerned about the structuring opportunities that two competing bases for consolidation would create. The Board concluded that reputational risk is not a sufficient basis for consolidation because it reflects only management's intentions (see also the discussion of management's intentions in paragraph BC24). Instead, the Board decided to propose that an entity should disclose the fact that it has provided support to unconsolidated structured entities without having a contractual or constructive obligation to do so.

4.3.3 The Board also observed that an entity's explicit commitment to support another entity is likely to be a liability that is accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

4.4 However, comments of BCBS and CEBS are noteworthy.

### **BCBS**

*"We do not view reputational risk by itself being a basis for consolidation. However, as mentioned earlier, we would recommend that reputational risk should be incorporated along with other elements of risks and rewards in the determination of whether one entity controls another. In order to promote a consistent and meaningful application of the risks and rewards approach, it could be useful to introduce in the standard a general presumption that the sponsor (or the primary beneficiary, etc.), being economically responsible for the economic results and performance of the sponsored structured entity, should control this entity, unless it demonstrates and declares in the notes of financial statement that it is not the case (ie it shall not support the structured entity – through credit enhancement, liquidity facility etc. - beyond what is legally due under existing contractual arrangements)".*

## **CEBS**

*“By itself we do not believe the exposure to reputational risk is an appropriate basis for consolidation, however we favour factoring this heavily into the criteria to assess whether the reporting entity has control.*

*However, we think the Board should consider establishing a presumption that an entity which establishes an SPE controls it, unless it explicitly declares in the notes to the financial statements that its involvement is limited to its contractual exposures, and that it will not grant support beyond what is legally due under contract.”*

Comments of BCBS and CEBS are almost identical and reflect the concerns of banking supervisors relating to reputational risk for banks owing to sponsoring of non-banking entities by them and also the consensus that the rules for accounting should give adequate weightage to reputational risks. Considering this, it may be appropriate for the banking regulators to stipulate harder/more conservative rules for consolidation of sponsored entities with banks.

### **4.5 Consequences of Consolidation**

Major consequence of consolidation vis-a-vis equity method of reporting is that under consolidation, the equity investment of the sponsor in the consolidated entity is knocked-off from its capital. Consolidation also improves the disclosure. The focus of capital adequacy norms is to capture the risks in the consolidated entity's assets to the extent these are not backed by the capital held by the consolidated entity. The issue here would be whether the sponsor would like the investors to bear the catastrophic losses, should these occur? If the sponsor is expected to bail out the consolidated entity out of reputational concerns, then the exposure of the sponsor goes beyond its equity investment and application of capital adequacy norms at group level only can take care of the entire spectrum of risks carried by the consolidated entity. This approach would essentially treat the investment by other investors in the PPC as liability of the PPC.

**Question 1**

**What are specific advantages to banks in diversifying into sponsoring and management of PPCs, in addition to that described in this Appendix?**

**Question 2**

**How critical is it for Indian economy to have Indian banks to participate in sponsoring and management of PPCs?**

**Question 3**

**What are other risks to banks in sponsoring and management of PPCs, in addition to that described in Appendix B?**

**Question 4**

**Should banks be completely prohibited to sponsor and manage PPCs? If not, should there be a limit to such activity?**

**Question 5**

**Given that the exposure of investors in the PPCs is essentially in the nature of an equity exposure, is it appropriate to require the sponsors to hold capital for such exposures?**

**Will it give rise to an asymmetry in the distribution of risks and rewards in that while banks would be expected to hold capital against the risks in the PPCs' balance sheets, they will not get sufficient return to compensate for it, as the non-anchor investors would be getting returns as equity investors, not as debt owners of the PPC. In that case, should the consolidation of PPCs not be equally based on 'control' and 'risk/rewards', rather than giving so much weight to 'control aspect' as is being given under ED-10.**

**Question 6**

**Is definition of 'control' given in ED-10 appropriate for the purpose of consolidation?**

**Question 7**

**Should 'control' be the sole criteria for consolidation?**

**Question 8**

**Basel-II Framework requires banks to consider holding capital against reputational risk. However, since measurement of reputational risk is difficult, this requirement has to be assessed under Pillar-II. Do banks run any reputational risk in sponsoring and managing PPCs? Do banks have reputational risk if they hold significant proportion of investments in a PPC, while they may have not sponsored that particular PPC?**

***Question 8***

**How should the reputational risk be factored in the regulatory framework so as to be a basis for requiring banks to hold capital for the PPCs assets? Do you agree with the view of BCBS and CEBS in this regard (Please see page No. 34)**

***Question 9***

**Can there be any circumstances when 'reputational risk' alone could be the basis of consolidation?**

***Question 10***

**Should Indian banks be permitted to finance LBOs undertaken by PPCs? If so, whether there should be a limit to such exposures?**

***Question 11***

**Will the consolidation of PPCs with the sponsors/investors lead to moral hazard and disincentivisation of the non-anchor investors to monitor the performance of the PPCs?**

**REFERENCES**

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<sup>ii</sup> President's Working Group on Common Approach to Private Pools of Capital - Guidance on hedge fund issues - focuses on systemic risk, investor protection on February 22, 2007. No- HP-272 available on Press Room of U.S Department of Treasury website. <https://treas.gov/press/releases/hp272.htm>

<sup>iii</sup> Recommendation #4 titled "Oversight of Private Pools of Capital" of 18 recommendation suggested by Group of 30.

<sup>iv</sup> Private Equity: Implications for Economic Growth in Asia Pacific by KPMG Private Equity Group in Asia Pacific in 2007.

<sup>v</sup> Private Equity: A discussion of risk and regulatory engagement: Feedback on DP 06/06, June 2007.

<sup>x</sup> Comment Letter of CFA Institute on ED-10 placed on the website of IASB.

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## **ISSUES IN CONSOLIDATION OF SECURITISATION SPVS AND CURRENT INTERNATIONAL THINKING**

### **1. Pre-crisis Rules**

Special Purpose Vehicles (SPVs)/Special Purpose Entities (SPEs) set up in connection with securitization transactions have been a matter of debate from the perspective of consolidation by the sponsors ever since these became prominent as off-balance sheet carriers of risks of parents without getting consolidated. The FASB in USA sought to plug the existing loop-holes in the accounting standards by amending FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities and issuing revised FIN 46(R) in December 2003, *Consolidation of Variable Interest Entities*, after collapse of Enron due to its off-balance sheet activities which had escaped consolidation as per existing accounting standards. FASB brought in concept of Qualifying SPV as per which unless SPV met the conditions for a Qualifying SPV it had to be consolidated. These rules focused on recognizing the significant residual risks by the sponsors of SPVs/SPEs, extending the scope of recognition beyond the interests measures by voting rights and equity investments. In 1998, IASB also issued SIC-12, to achieve similar objectives.

### **2. Inadequacies highlighted by the crisis**

However, the sub-prime crisis established beyond doubt that the above accounting provisions are insufficient to capture all the residual risks retained by the sponsors. More particularly, it was found that many SPEs/SIVs sponsored by the banks had to be provided liquidity support, even though the existing accounting rules did not explicitly require consolidation of these SIVs by the banks. Thus, the risks carried by the SPVs escaped recognition in the group level balance sheets of banks concerned. The ongoing efforts at the IASB and FSAB are aimed at improving the existing accounting norms in this regard.

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### **3. Revised accounting rules regarding SPEs**

Accounting standards and regulatory capital requirements play an important role in the motivations for the use of SPEs. In some cases, sponsoring firms may be motivated to use SPEs to achieve off-balance sheet accounting treatment for assets, leading to improved financial and capital ratios for the firm. By holding assets off-balance sheet, the sponsoring institution might benefit from the ability to show better financial ratios, such as a higher return on assets. Generally, off-balance sheet treatment is easier to achieve under US GAAP than under IFRS. However, recent changes to US accounting rules relating to SPEs that are effective in 2010 will significantly reduce the ability of certain transactions to qualify for off-balance sheet treatment.

#### **3.1 International Financial Reporting Standards(IFRS)**

Under IFRS, off balance sheet treatment for an SPE involves two stages. Firstly, an assessment needs to be made as to whether a sponsor consolidates an SPE. The second assessment is whether the transferred asset, such as a pool of mortgage loans transferred to the SPE, can be derecognised by the sponsor institution.

An SPE is consolidated when the substance of the relationship between the sponsor and the SPE indicates that the SPE is controlled by the sponsor. SIC-12 governs this assessment under IFRS. To determine the substance of the relationship between the sponsor and the SPE the following factors must be considered using SIC-12, as they are circumstances which may indicate that the sponsor controls an SPE and consequently should consolidate:

- in substance, the activities of the SPE are being conducted on behalf of the sponsor according to its specific business needs, so that the sponsor obtains benefits from the SPE's operation;

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- in substance, the sponsor has the decision-making power to obtain the majority of the benefits of the activities of the SPE or, by setting up an 'autopilot' mechanism, the sponsor has delegated these decision-making powers;
  - in substance, the sponsor has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or
  - in substance, the sponsor retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

An individual criterion by itself may not necessarily indicate control, but rather all the indicators and any other relevant facts and circumstances need to be assessed in balance when assessing control of an SPE.

SIC-12 is an interpretation of IAS 27 (which provided consolidation principals for entities which are not narrowly defined). SIC-12 was written as an anti-abuse measure to prevent entities from manipulating financial statements through the use of financial engineering. Application of SIC-12 results in consolidation of many vehicles that would have otherwise resulted in off-balance sheet treatment.

Derecognition of assets transferred to the SPE is governed by IAS 39 and is based on the principle that a transferor should not retain substantially all the risk and rewards of the cashflows relating to a transferred asset. If substantially all the risks and rewards have been transferred, the asset is derecognised. If substantially all the risks and rewards have been retained, derecognition of the asset is precluded.

### **3.1.1 Revised rules for consolidation (as per ED-10 of IASB)**

The International Accounting Standards Board (IASB) has published ED 10, "Consolidated financial statements" which is expected to replace the existing IAS 27 and SIC 12. It proposes a single control-based model as the basis for consolidation and provides guidance on how to apply that definition in particular situations that have been found difficult when applying IAS 27 and SIC-12. The model defines control as being



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made up of two components: power to govern an entity and exposure to returns (both positive and negative) from that entity. The exposure draft introduces the term 'structured entity' which is similar in scope to SPEs as defined in SIC-12.

As per ED-10, when assessing control of a structured entity, it is necessary to identify how returns from the entity's activities are shared and how decisions, if any, are made about the activities that affect those returns. A reporting entity shall consider all relevant facts and circumstances, including the following:

- (a) the purpose and design of the structured entity ( paragraph 32 of ED-10)
- (b) the reporting entity's returns from its involvement with the structured entity (paragraph 33)
- (c) the activities of the structured entity, including the extent to which the strategic operating and financing policies that direct those activities have been predetermined ( paragraphs 34–36)
- (d) related arrangements (paragraph 37)
- (e) the reporting entity's ability to change the restrictions or predetermined strategic operating and financing policies ( paragraph 38)
- (f) whether the reporting entity acts as an agent for other parties, or another party acts as its agent (paragraphs B3–B8).

### **3.1.2 Revised rules for de-recognition of assets- ED/2009/3- De-Recognition**

ED-2009/3 is part of the joint effort of IASB and FSAB to strengthen the rules for de-recognition of financial instruments transferred to other entities. While ED-2009/3 improves the rules for de-recognition of assets and liabilities especially in the context of use of SEs, enhances disclosures, FSAB ( FAS 166) amends FAS 140 *Accounting For Transfers And Servicing Of Financial Assets And Extinguishments Of Liabilities* to

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achieve similar objectives. Major changes proposed to be introduced by ED-2009/03 in the context of de-recognition of securitised assets are summarized below:

As regards de-recognition of transferred assets, IAS 39 has two major problems:

- (i) It is internally inconsistent as it combines elements of various de-recognition concepts (risks and rewards, control and continuing involvement) and requires them to be applied in a specified order to determine whether all or part of a previously recognized financial asset should be derecognised.
  - IAS 39 permits a financial asset to be separated into parts only in defined circumstances. Otherwise it requires the derecognition tests to be applied to the entire asset.
  - An entity must consider whether it has 'transferred' the asset to another party and, if so, whether it has also transferred substantially all the risks and rewards of the asset. If so, the entity derecognises the asset.
  - Otherwise the entity determines whether it has retained control of the asset. If it has retained control of the asset, the entity recognises the asset only to the extent of its 'continuing involvement' in the asset. If it has not retained control of the asset, the entity derecognises the asset.
- (ii) It provides little guidance about how the 'substantially all the risks and rewards' test should be applied.

ED-2009/03 addresses the above issues as under:

- (i) It does not combine elements of several de-recognition concepts but rather focuses on a single element (control).
- (ii) Unlike IAS 39, the de-recognition approach proposed in ED-2009/03 does not have:
  - (a) a test to evaluate the extent of risks and rewards retained;
  - (b) specific pass-through requirements; or

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- (c) a requirement for a transferor (in a transfer that fails de-recognition) to re-cognise and measure a financial asset to the extent of its continuing involvement.

### 3.2 US GAPP

In USA, the accounting rules regarding VIEs (SPVs) broadly fall in two categories: (i) Rules defining SPVs and possible consolidation thereof by the sponsors (ii) Rules regarding de-recognition of assets transferred to SPVs. The accounting rules for consolidation of SPVs with the sponsors are contained in applying FASB Interpretation No. 46 R (revised December 2003), *Consolidation of Variable Interest Entities*. The rules for de-recognition of assets are contained in FASB Statement No.140- *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. FASB has recently amended both FIN 46(R) and FAS 140 to strengthen the accounting rules for consolidation of SPVs and de-recognition of assets. In USA, SPVs are called as Variable Interest Entities.

<sup>1</sup>Prior to FASB *Interpretation No.46R*, "Consolidation of Variable Interest Entities\_(VIE)," December 2003 (FIN 46R), the assets, liabilities, and results of operations for VIEs and other entities frequently were not consolidated with those of the firm that controlled the entity. FIN 46R first describes how to identify a VIE that is not subject to control through voting ownership interests but is nonetheless controlled by another enterprise and therefore subject to consolidation. Each enterprise involved with a VIE must determine whether the financial support it provides makes it the primary beneficiary of the VIE's activities. The VIE's primary beneficiary is then required to include the assets, liabilities and results of the activities of the VIE in its consolidated financial statements.

According to FIN 46R, an entity qualifies as a VIE if either of the following conditions exist:

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- The total equity at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties, including equity holders. In most cases, if equity at risk is less than 10 percent of total assets, the risk is deemed insufficient.
  
  - The equity investors in the VIE lack any one of the following three characteristics of a controlling financial interest:
    1. The direct or indirect ability to make decisions about an entity's activities through voting rights or similar rights.
  
    2. The obligation to absorb the expected losses of the entity if they occur (e.g., another firm may guarantee a return to the equity investors).
  
    3. The right to receive the expected residual returns of the entity (e.g., the investors' return may be capped by the entity's governing documents or other arrangements with variable interest holders).

In assessing whether an enterprise should consolidate the assets, liabilities, revenues, and expenses of a VIE, FIN 46R next relies on an expanded notion of a controlling financial interest. The following characteristics indicate an enterprise qualifying as a primary beneficiary with a controlling financial interest in a VIE.

- The direct or indirect ability to make decisions about the entity's activities.
- The obligation to absorb the expected losses of the entity if they occur.
- The right to receive the expected residual returns of the entity if they occur.

It may be noted that these characteristics mirror those that the equity investors lack in a VIE. Instead, the primary beneficiary is subject to the majority of risks of losses or entitled to receive a majority of the entity's residual returns or both. The fact that the primary beneficiary may own no voting shares whatsoever becomes inconsequential because such shares do not effectively allow the equity investors to exercise control. Thus, in assessing control, a careful examination of the VIE's governing documents and

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the contractual arrangements among the parties involved is necessary to determine who bears the majority risk.

### <sup>2</sup>Qualifying Special Purpose Entities

Under U.S. GAAP, it is possible to structure a special purpose entity that does not meet the variable interest criteria in FIN 46R. Qualifying special purpose entities (QSPE) are structured to avoid consolidation and must meet qualification criteria. The use of QSPEs has increased in recent years, probably as a consequence of FIN 46R requiring consolidation. Under U.S. GAAP, the QSPE is independent and legally separate from the sponsor and has total control over the purchased asset. The QSPE can hold only financial assets. The sponsoring company does not have effective control over the assets and is not the primary beneficiary. The financial risk of the sponsor is limited, for example, to its investment or explicit recourse obligation in the SPE. In other words, the sponsor is *bankruptcy remote*. SFAS No. 140 provides guidance for situations in which the transfer of an asset to the QSPE is considered to be a sale to an independent entity. The sponsor company removes the asset from the balance sheet and recognizes a gain or loss on the sale. IFRS do not permit QSPEs.\*

While the readers interested in greater details about Variable Interest Entities, their consolidation with parents and de-recognition of assets by the originator may refer to these accounting standards available on the website of FASB, main modifications to them carried out recently as per FAS 166 and 167 in this regard are summarized below.

### **3.2.1 FAS-166- Accounting for Transfer of Assets**

This statement essentially amends FASB Statement NO.140. *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. Main provisions of FAS 166 are as under:

**3.2.1.1** This Statement removes the concept of a qualifying special-purpose entity from Statement 140 and removes the exception from applying FASB Interpretation No. 46 R

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(revised December 2003), *Consolidation of Variable Interest Entities*, to qualifying special-purpose entities.

**3.2.1.2** It clarifies that the objective of paragraph 9 of Statement 140 is to determine whether a transferor and all of the entities included in the transferor's financial statements being presented have surrendered control over transferred financial assets. That determination must consider the transferor's continuing involvements in the transferred financial asset, including all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer, even if they were not entered into at the time of the transfer. The definition of continuing involvement has been sufficiently expanded to reflect the lessons learnt from the crisis. This Statement modifies the financial-components approach used in Statement 140 and limits the circumstances in which a financial asset, or portion of a financial asset, should be derecognized when the transferor has not transferred the entire original financial asset to an entity that is not consolidated with the transferor in the financial statements being presented and/or when the transferor has continuing involvement with the transferred financial asset.

**3.2.1.3** It defines the term *participating interest* to establish specific conditions for reporting a transfer of a portion of a financial asset as a sale. If the transfer does not meet those conditions, a transferor should account for the transfer as a sale only if it transfers an entire financial asset or a group of entire financial assets and surrenders control over the entire transferred asset(s) in accordance with the conditions in paragraph 9 of Statement 140, as amended by this Statement.

**3.2.1.4** The special provisions in Statement 140 and FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, for guaranteed mortgage securitizations are removed to require those securitizations to be treated the same as any other transfer of financial assets within the scope of Statement 140, as amended by this Statement. If such a transfer does not meet the requirements for sale accounting,

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the securitized mortgage loans should continue to be classified as loans in the transferor's statement of financial position.

**3.2.1.5** This Statement requires that a transferor recognize and initially measure at fair value all assets obtained (including a transferor's beneficial interest) and liabilities incurred as a result of a transfer of financial assets accounted for as a sale.

**3.2.1.6** Enhanced disclosures are required to provide financial statement users with greater transparency about transfers of financial assets and a transferor's continuing involvement with transferred financial assets.

### **3.3 FAS-167 – Amendment To FASB Interpretation Of FIN (46)R**

**3.3.1** While ED/2009/3 improves the definition of control for the SEs, FAS -167 improves the definitional aspects of control of VIEs and introduces additional reconsideration events and re-assessment requirements.

**3.3.2** This Statement amends Interpretation 46(R) to require an enterprise to perform an analysis to determine whether the enterprise's variable interest or interests give it a controlling financial interest in a variable interest entity. This analysis identifies the primary beneficiary of a variable interest entity as the enterprise that has both of the following characteristics:

- a. The power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance
- b. The obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity.

**3.3.3** Additionally, an enterprise is required to assess whether it has an implicit financial responsibility to ensure that a variable interest entity operates as designed when determining whether it has the power to direct the activities of the variable interest entity that most significantly impact the entity's economic performance.

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**3.3.4** This Statement amends Interpretation 46(R) to require ongoing reassessments of whether an enterprise is the primary beneficiary of a variable interest entity. Before this Statement, Interpretation 46(R) required reconsideration of whether an enterprise is the primary beneficiary of a variable interest entity only when specific events occurred. This Statement amends Interpretation 46(R) to eliminate the quantitative approach previously required for determining the primary beneficiary of a variable interest entity, which was based on determining which enterprise absorbs the majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both.

**3.3.5** This Statement amends certain guidance in Interpretation 46(R) for determining whether an entity is a variable interest entity. It is possible that application of this revised guidance will change an enterprise's assessment of which entities with which it is involved are variable interest entities.

**3.3.6** This Statement amends Interpretation 46(R) to add an additional reconsideration event for determining whether an entity is a variable interest entity when any changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity's economic performance.

**3.3.7** This Statement amends Interpretation 46(R) to require enhanced disclosures that will provide users of financial statements with more transparent information about an enterprise's involvement in a variable interest entity. The enhanced disclosures are required for any enterprise that holds a variable interest in a variable interest entity. This Statement nullifies FASB Staff Position FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities*. However, the content of the enhanced disclosures required by this Statement is generally consistent with that previously required by the FSP.



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#### **4. Managing risks associated with sponsoring of SPEs**

The recent crisis has highlighted the need for managing risks associated with the activity of sponsoring SPVs especially the securitisation SPVs. The risk management aspects of SPVs are discussed below:

4.1 Different variants of SPVs could be used by banks to effect risk transfer. In structures such as CDOs, SIVs and RMBs a high level of risk transfer is achieved, whereas programs such as covered bonds, certain ABCP conduits, and credit card securitisations could potentially retain a significant amount of residual risk including on account of reputational concerns. The level of risk retention would depend upon the seniority of the tranche retained by the originator. Generally, the originators would have the advantage of having more information than the investors which could be used by them to determine the most economically efficient risk transfer they would like to achieve.

4.2 The level of due diligence may depend upon whether the originators intend to use securitisation as a means of capital relief or as a source of borrowing. In particular, the assets originated with the sole intention of securitisation may not receive adequate level of due diligence, as has been seen during the current crisis. The usual belief that the originator would always ensure good quality of assets due to the need for continuously remaining in the market has also not been totally correct.

4.3 If the originators believe that the assets have been effectively transferred from their balance sheet they would normally not include them in their firm-wide risk management, even though later on they may find themselves lending implicit support to the entities to which these assets have been transferred. During the crisis some investors were observed not to have conducted adequate independent due diligence to understand the risk profiles of SPE transactions. For instance, investors in US RMBS transactions seemed unaware of issues concerning credit quality and asset performance. In contrast, European SPE investors were not familiar with the structural

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features of the transactions and were not able to access analytics and modelling resources for the securities held.

**4.4** At a minimum, the following measures could be taken by the originators to manage the risks associated with securitisation SPEs sponsored by them:

- (i) All parties to a securitisation transaction should be able to assess and have capability to manage the risk factors that increase transaction complexity, such as structural features of an SPE, including triggers and the roles of parties involved, level of true sale achieved, implicit support extended by the originator, regulatory legal and accounting rules governing such transactions.
- (ii) Banks should ensure that the SPE has put in place governance process which is commensurate with the complexity of the structure.
- (iii) Banks should have the capability to monitor the performance of the SPVs sponsored by them and aggregate, assess and report all their SPE exposure risks, as part of their overall risk profile.
- (iv) If a sponsor is found to be extending non-contractual support to an SPE, then the activities/assets of that SPE should be consolidated with those of the institution for both supervisory assessment and internal risk management purposes.

<sup>1</sup> Hoyle, Schaefer and Douppnik, Reading 22, Financial Reporting and Analysis, CFA Programme Curriculum, Volume 2, Level II, CFA Institute, USA

<sup>2</sup> Susan Perry Williams, Reading 21, Financial Reporting and Analysis, CFA Programme Curriculum, Volume 2, Level II, CFA Institute, USA

**Question 1**

**Should RBI issue regulatory guidelines on consolidation of Securitisation SPVs for the purpose of capital adequacy or should this be left to be taken care of by Indian Accounting Standards as and when modified in the light of modifications to corresponding standards issued by IASB and/or FASB?**

**Question 2**

**Is there a need for issuing any fresh guidance to banks in the matter or the existing 'True Sale' criteria contained in RBI guidelines on securitization ( please see page 4 & 5 of this DP) are sufficient?**

**Question 3**

**Are the provisions of ED-2008/10, ED-2009/03, FAS-140 ( as amended by FAS-1666) and FIN(46(R) as amended by FAS-167) sufficient to ensure adequate capturing of risks inherent in securitization?**

**APPENDIX C****PROPOSED FRAMEWORK FOR REGULATION OF  
BANKS' EXPOSURE to 'SPONSORED ENTITIES'****1. Venture Capital Funds/Private Equity Funds/Mutual Funds**

It is recognised that PE is a major alternative asset class used by most institutional investors including banks to increase their returns and diversify the existing portfolios. However, considering the recent international developments as discussed in this Paper and the inherently high risks involved in sponsoring and management of PPCs(VCFS and PEFs), a prudent regulator, would like to see only limited involvement of banks in this business. Further, the higher risks in this activity/investment should be managed efficiently and supported with adequate capital. Similarly, the sponsoring of Mutual Funds also remain a risk activity from the perspective of reputational risks for banks despite their diversified asset base. In view of these considerations, the following

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regulatory framework is proposed for banks' involvement in PPCs, in addition to the existing norms prescribed in DBOD circular DBOD.No.FSD.BC.18/24.01.001/2009-10 dated July 1, 2009.

## **1.1 Sponsoring and management of investment in PPCs including Mutual Funds**

**1.1.1** Banks should normally not have a strategic interest in the AMCs managing the PPCs/Funds and the Fund itself. This can be ensured by not having controlling/significant interest in the AMCs/Funds.

### *Controlling interest*

A bank will be deemed to be controlling an AMC/ Fund if it attracts any of the provisions of para 1.2 below

### *Significant interest*

A bank will be deemed to have a significant interest in the AMC/Fund if it has equity investment ranging from 20 to 50% (both figures inclusive) in the AMC or controls voting rights of the AMC from 20 to 50% (both figures inclusive) managing the Fund. A bank will also be deemed to have significant interest in the Fund if its investment in the fund ranges between 20-50% of the corpus. The investments made in the AMCs/Funds by the companies which are subsidiaries/step-down subsidiaries of the bank, will be deemed to be the investments made by the bank itself. However, the investments made by the associates/joint ventures of the bank in the AMC/Fund will be counted for the purpose of the 20% limit based on the proportional shareholding of the bank in such entities. The investments within this limit can be made by the bank without seeking approval of RBI.

**1.1.2** Banks should normally not invest in excess of 50% of the corpus of a PPC.

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### 1.1.3 Capital adequacy requirements

In cases where a bank, or any of its subsidiaries/associates/joint ventures, or both bank and these entities together, intend to make an investment in AMC/Funds which would be deemed as a controlling or significant interest as defined above, e.g. in pursuance of inter-governmental co-operation agreements entered into by GOI with other Governments, such investments could be made by the bank with prior approval of RBI or the GOI, as the case may be, subject to the following minimum capital requirement on account of potential reputational risk for the bank are stipulated as under:

#### 1.1.3.1 Capital Adequacy norms for banks' exposure to AMCs/Funds deemed as 'controlled' by the bank

- (i) A bank's direct investment in the AMC/Funds where the bank is deemed to have controlling interest will be deducted from its capital ( 50% from Tier I and 50% from Tier II capital)
- (ii) A bank will deemed to have a **high reputational risk** on account of its involvement with the Funds which are deemed as controlled by it in terms of above norms. The bank will, therefore, have to maintain capital treating the total assets of the Fund (net of its own investments) as its off-balance sheet exposure with a CCF of 50% and a risk weight of 100%.

#### 1.1.3.2 Capital adequacy norms for banks' investment in AMCs which are treated as 'significant interests'

- (i) A bank's direct investment in the AMC where the bank is deemed to have a significant interest will be deducted from its capital ( 50% from Tier I and 50% from Tier II capital)

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(ii) A bank will be deemed to have **a significant reputational risk** on account of its involvement with the Funds where a bank holds significant interest in the AMC as defined in para 1.1.1 above. The relevant exposure will be the equity investment in the Funds made by non-sponsor entities. For the purpose of capital adequacy, these exposures would be treated as under:

(a) The exposure will be measured as an off-balance sheet exposure, as a portion of the AMC of the total outside liabilities of the Fund as computed at para (a) above, in proportion to the bank's stake in the AMC.

(b) The exposure computed at para (b) above will be converted into a credit equivalent amount by applying a credit conversion factor of 20%.

(c) The exposure computed at para (c) above, will be assigned a risk weight of 100%.

(d) The RBI would reserve the right to periodically review this stipulation and scale up or down the capital requirement, if required.

#### **1.1.3.3 Capital Adequacy and Valuation Norms for banks' Own Investments in the VCF/PEF other than that included in para 1.1.3.1 and 1.1.3.2 above**

a) All such investments will be assigned a risk weight of 200% (specific capital charge of 18% in the case of investments held under AFS).

**b) As per existing RBI guidelines, investments made in the form of venture capital can be classified under HTM category for an initial period of 3 years. The investments made in the forms other than venture capital will be classified straight away under AFS on acquisition. *For this purpose, the 'venture capital' is defined as any unlisted investment made by the PEF in the initial equity of a company at the time of implementation of the new/expansion project i.e. it is not a secondary market purchase.***

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- c) In cases where the PEFs, as per their documented investment policies, are authorized to engage in LBOs, in view of higher risk caused by higher leverage involved in such transactions, the risk weight on the banks' investment in such PEFs will be 250% ( specific capital charge of 22.5%) in cases where the bank's investment in the PEF is within the limit of 20% indicated in para 1.1.1, and 300% ( specific capital charge of 27%) in other cases.

***Note: No change is proposed for capital charge on banks' investment in MFs.***

## **1.2 Definition of AMCs/Funds controlled by the bank**

An AMC/Fund will be deemed to be controlled by a bank if:

- (i) The bank presents financial statements that consolidate the AMC's/Funds assets, liabilities, equity, income, expenses and cash flows with those of the entities that it controls.
- (ii) A bank controls the AMC/Fund when it has the power to direct the activities of the AMC/Fund to generate returns for the bank.
- (iii) The following paras explain what is meant by power to direct control:

### **1.2.1 AMCs**

#### **Power to direct activities with a majority of the voting rights**

- a) A bank can have the power to direct the activities of AMC by having the power to appoint or remove the members of that AMC's governing body that have more than half of the voting rights within that body, if the determination of strategic operating and financing policies is by that body.
- b) If the appointment or removal of the members of the AMC's governing body is determined by voting rights, the bank with more than half of those voting rights

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controls that governing body and has the power to direct the activities of that entity unless paragraph (c) applies.

### **Majority of the voting rights but no power to direct activities**

- c) A bank with more than half of the voting rights of the AMC might not have the power to direct the activities of that AMC. This situation will exist if legal requirements, the founding documents of the other entity or other contractual arrangements restrict the power of the reporting entity to the extent that it does not have the power to direct the activities of the entity, or if another *party* has the power to direct the activities of the entity. For example, if an entity in which a reporting entity has more than half of the voting rights is placed under legal supervision, the reporting entity is prevented from having the power to direct the activities of that entity and does not control that entity.

### **Power to direct activities without a majority of the voting rights**

- d) A bank can have the power to direct the activities of AMC even if it holds less than half of the voting rights of that entity. A bank with less than half of the voting rights will be deemed to have the power to direct the activities of AMC if:
- i. the bank has more voting rights than any other party; and
  - ii. the bank's voting rights are sufficient to give the bank the ability to determine the AMC's strategic operating and financing policies. For example, a reporting entity can have the power to direct the activities of another entity if the reporting entity is the dominant shareholder that holds voting rights and all the other shareholders with voting rights are widely dispersed and are not organised in such a way that they actively co-operate when they exercise their votes so as to have more voting power than the reporting entity.
  - iii. A bank will be deemed to have the power to direct the activities of a AMC if it actually provides non-contractual support below market rates out of reputational concerns when the AMC faces distress.
  - iv. A bank holds more than 50% equity of the AMC, even if it does not control proportionate amount of voting rights.

## **1.2.2 PEF/VCF**



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- a) A bank will be deemed to have the power to direct the activities of a Fund if in terms of para 1.2.1 above the bank has power to direct the activities of the AMC.
  - b) A bank will be deemed to have power to direct the activities of a Fund if the bank holds units of the Fund to an extent that it gives it very significant rights such as a right to liquidate the fund, remove the Fund manager/change the AMC of the Fund. In any case, a bank holding more than 50% units of Fund will be deemed to have power to direct the activities of a Fund.

### **1.3. Lending to PEFs/VCFs**

Banks may lend to PEFs including for the purpose of **buyouts**, subject to the following conditions:

- (a) Such lending will be reckoned for the purpose of compliance with the regulatory ceiling for capital market exposure.
- (b) It will be assigned a risk weight of **200%**.
- (c) A margin of 50%.

### **2. Sponsoring of Securitisation SPVs**

When assessing control of a Special Purpose Vehicle/ Structured Entity, it is necessary to identify how returns from the entity's activities are shared and how decisions, if any, are made about the activities that affect those returns. A bank shall consider all relevant facts and circumstances, including the following:

- (a) the purpose and design of the structured entity
- (b) the reporting entity's returns from its involvement with the structured entity
- (c) the activities of the structured entity, including the extent to which the strategic operating and financing policies that direct those activities have been predetermined

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- (d) related arrangements
  - (e) the reporting entity's ability to change the restrictions or predetermined strategic operating and financing policies
  - (f) whether the reporting entity acts as an agent for other parties, or another party acts as its agent

## **2.1 Purpose and design**

Understanding the purpose and design of a structured entity helps assess how the activities of that entity are directed and how returns are shared among its participants. For example, a bank is likely to control a structured entity that has been created to undertake activities that are part of its ongoing activities (eg the entity might have been created to hold legal title to an asset that the bank uses in its own activities, providing a source of financing for the bank). The bank is unlikely to surrender power to direct such a structured entity's activities because of the importance of those activities to the bank's activities.

## **2.2 Returns**

Generally, the more a bank is exposed to the variability of returns from its involvement with an entity, the more power the bank is likely to have to direct the activities of that entity that cause the returns to vary. A bank is likely to have power to direct the activities of a structured entity if it is exposed to the variability of returns that are potentially significant to the structured entity and the bank's exposure is more than that of any other party.

## **2.3 Activities**

Control of an entity that has a limited range of activities, such as an entity that manages an asset securitisation, is determined on the basis of how that limited range of activities is directed and how the returns it receives from its involvement with the entity are shared. A bank identifies what activities cause the returns to vary and assesses whether

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it has power to direct those activities. A bank's ability to act when circumstances arise or events happen constitutes power if that ability relates to the activities that cause the bank's returns to vary. A bank does not have to exercise its power in order to have power to direct the activities of a structured entity.

For example, if the only assets of an entity are receivables, then managing any defaulting receivables is the only activity that causes the returns to vary and, thus, affects the returns of the structured entity's participants. In this example, the party with the power to direct how any defaulting receivables are managed, and in having that power can affect its returns from its involvement with the entity, controls that entity. A party has that power by managing any defaulting receivables itself or by delegating to its agent the management of defaulting receivables. That party has the power to direct the activities of the entity irrespective of whether any of the receivables actually defaults.

Sometimes some activities of a structured entity are directed by means of predetermined strategic operating and financing policies that specify the actions that must be taken in response to anticipated events or circumstances. Such predetermined policies can give a bank the power to direct those activities. Those policies are often, although not always, implemented by an agent of the party with the power to direct those activities (Please see ED-10 and the related documents for more details especially paragraphs B3–B8).

## **2.4 Related arrangements**

A bank can control a structured entity by means of related arrangements (see paragraphs 17 and 18 of ED-10). For example, a bank could establish a structured entity, whose founding documents restrict its activities to purchasing fixed rate

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receivables of the bank for cash, collecting payments from those receivables and passing those payments to the investors in the structured entity. Receivables that are overdue by more than a specified period are put back to the bank. In this example, in the absence of other facts, the bank controls the structured entity. The entity's founding documents and the put agreement ensure that the bank is exposed to all of the variability of returns generated from the receivables of the structured entity, and has the ability to affect those returns by managing any defaulting receivables. The bank has the power to direct the activities of the structured entity by having the ability to direct how the assets of the structured entity are managed.

### **2.5 Ability to change restrictions or predetermined strategic policies**

A bank can have the power to direct the activities of a structured entity if the bank has the ability to change the restrictions or predetermined strategic operating and financing policies according to which the structured entity operates. For example, a bank can have the power to direct the activities of a structured entity by having the right to dissolve the entity or to change (or veto any changes to) the entity's charter or bylaws. A bank can have the right to dissolve an entity by holding liquidation, redemption or other rights.

### **3. Criteria for de-recognition of assets**

The changes brought out through FAS 166 and proposed under ED-2009/03 of IASB are basically aimed at removing the complexity of the existing provisions. As these are primarily accounting issues rather than regulatory and the true sale criteria contained in RBI guidelines are fairly stringent, it is proposed not to issue any further guidance in this regard. Nevertheless, RBI would encourage banks to implement asset de-recognition criteria contained in AS-30 immediately in so far as it is more stringent than RBI Guidelines. RBI would also request ICAI to consider need for making amendment to AS-30 on the lines of proposed revisions contained in ED-2009/03 of IASB and also FAS 166.

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## **4. Proposed regulatory Framework**

### **4.1 Capital Adequacy**

If an SPV is determined to be controlled by the sponsored bank as per above rules, by the bank itself, or by the Annual Financial Inspection Team of RBI during the inspection of the bank or during any special scrutiny of the bank by RBI, the bank will, for the purpose of capital adequacy norms, have to treat the securitized assets as if these were never securitized and the amount received as sale consideration as a secured borrowing. Besides, as per existing guidelines, the securitised assets will continue to be treated as on-balance sheet exposure if the true sale criteria are violated. In all such cases, any on or off-balance sheet liabilities of the SPV to others will also be treated as liabilities of the bank.

### **4.2 Exposure Norms**

The investments held by the PPCs controlled by a bank and the assets of securitized SPVs deemed to be controlled by a bank will be reckoned for the purpose of single borrower/group of borrowers exposure norms.

### **4.3 Risk Management at Group level**

The assets and liabilities of the PPCs and SPVs controlled by a bank should be considered while assessing the credit concentration risks, liquidity risk, asset liability mismatches and interest rate risk in the banking book at the group level.

***Question 1***

**Should the consolidation of securitisation SPVs for the purpose of capital adequacy, exposure norms and risk management be based on IASB standards or FASB Standards or a mix of both? What specific suggestions do you have, in case you differ with the proposals made above?**

***Question 2***

**Do you agree with the above proposals regarding capital adequacy and exposure norms for banks' exposures to PPCs? If not, what are your specific suggestions against each proposal? Please give rationale for the suggestions?**

***Question 3***

**Should the capital requirements in respect of banks' exposure to PPCs be part of Pillar 1 or Pillar II of Basel-II or, should there be a minimum capital requirement under Pillar 1 with provision for an add-on under Pillar-II?**

***Question 4***

**Should RBI also consider modification of its guidelines on securitization of assets to incorporate provisions based on amendments to accounting standards relating to de-recognition of securitized/transferred assets, carried out recently by IASB and FASB as mentioned in this Appendix?**

***Question 5***

**For the purpose of application of exposure norms and risk management guidelines at a group level, should the consolidation of PPCs be confined to only those PPCs which are deemed to be controlled by the bank or also the PPCs where banks hold significant influence?**

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The unprecedented nature of the global debt market has helped fuel the PE boom till the financial crisis and subsequent slowdown in the western world.

Its reasons can be broadly stated as :

- Low interest loans – driven by high levels of liquidity prevalent at that time and the reduction in risk spreads.
- High leverage – there is no doubt that in the larger deals across the world, the banks have also loosened their lending requirements, helping to drive the record volume of leveraged buyouts. And it is this leverage that changed significantly over the past four years (till 2007); according to Standard and Poor’s analysis, in 2001 deals were being done at 4x EBITDA while in the first half of 2007 they were being done at over 6x EBITDA in USA (source: “Ratings Direct Report”, Standard & Poor’s, July 2007)
- Favourable financing structures – particularly covenant-lite financing arrangements which lacked the protective covenants that subject the borrower to tests to show they are maintaining financial ratios at agreed levels. One covenant lite feature was ‘**Toggle Notes**’ which allowed borrowers to either make interest payments in cash or borrow more money to pay interest on the money already borrowed.
- Collateral requirement – loosened where there was no security over assets/business for the loans.
- Bridge loan facilities – typically were provided by the bank’s capital markets arm with the understanding that the buyout firms would find investors to take over the bank’s stake after the deal closed.

The key factor that makes the Asia Pacific region so compelling for private equity fund managers is the economic growth of the region – 94 percent of respondents of a KPMG study singled this out (given below). It is not surprising, therefore, to find that the market receiving the most interest from private equity funds is China. Economic growth eclipsed other considerations such as pricing, deal flow and competition. The upward pressure on the pricing of deals in Europe and the US has also made the region more interesting, with very few respondents mentioning low labour costs as a factor. (KPMG study)

Sr.	Factors	Percentage of PE firms who felt this factor to be a reason
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1	Economic growth	94%
2	Pricing	26%
3	Deal flow / Investment opportunities	23%
4	Demographics	15%
5	Less competition	13%
6	Market size	8%
7	Quality of management/entrepreneurs	8%
8	Local knowledge/networks	7%
9	Skilled workforce	7%
10	Market inefficiencies	6%
11	Stability	6%
12	Sophisticated capital markets	5%
13	Technology	5%
14	Regulation	4%
15	Labour costs	4%
16	Exit opportunities	3%
17	Manufacturing capabilities	2%
18	Debt markets	2%

*Source: KPMG survey of 119 private equity firms in Asia Pacific, 2007*

Six out of ten respondents say their private equity fund has assets in China. India is in a distant second (37 percent), followed by Australia (29 percent), Singapore (29 percent) Taiwan (28 percent) and Japan (21 percent). Of our sample set, the least penetrated markets are Vietnam (10 percent), the Philippines (8 percent), and Mongolia (3 percent). (KPMG)



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## 1. International Scenario: (studies done by different multilateral bodies)

Below is depicted experience of different developed countries (e.g USA, UK, other EU countries, Australia) in regard to PE and VC investments.

### 1.1 The World Economic Forum (WEF) study

The World Economic Forum (WEF) study analyses global leveraged buyout (LBO) activity, exit behaviour and holding periods using a data set of more than 21,000 LBO transactions from 1970 to 2007. It estimates the total value of the firms acquired in these transactions to be \$3.6 trillion, out of which \$2.7 trillion represent LBOs undertaken after 2000. Most LBO activity consists of acquisitions of private rather than public firms and LBOs provide a net positive flow of firms to public markets over the long run. The study finds that LBO holding periods are longer than what has been thought of previously. Only 8% of firms in EU stay in LBO ownership for less than two years and the median firm stays in LBO ownership for about nine years.

The WEF study mentions divergent views on the role of LBOs in the economy. A few of them are as below. Whereas Jensen (1989), argues that the LBO organizational firm is a long-term superior governance structure that imposes strong investor monitoring and managerial discipline through a combination of ownership concentration and substantial leverage. Rappaport (1990), on the other hand, views LBOs as a short-term “shock therapy” that allows inefficient, badly performing firms with inferior corporate governance to enter a quick but intense period of corporate and governance restructuring, in order to return to public ownership in a few years. Kaplan (1991) found a median time in private ownership of 6.8 years and concluded that leveraged buyouts are “neither short-lived nor permanent”.

These days, LBO transactions occur worldwide in a variety of industries and target both private and public companies. In addition, there seems to be an increase in so-called “secondary buyouts”, where one LBO sponsor exits its investment by selling the firm to a new LBO fund sponsor, which could imply that the organizational form is becoming more permanent.

There has long been a debate whether the benefit of an LBO is restricted to a handful of people when public firms are taken out of listing and made private. As per the WEF study, out of the 21,397 leveraged buyout transactions that took place from 1970 to 2007, more than 40% took place after 1 January 2004. The estimate is that the total value of firms (both equity and debt) acquired in leveraged buyouts to be \$3.6 trillion over the sample period, of which \$2.7 trillion worth of transactions occurred between 2001 and 2007. WEF study shows that public-to-private transactions only account for 6.7% of all transactions, representing 28% of the combined values of firms acquired. Most leveraged buyouts are acquisitions of private firms or divisions of other companies. The study also shows that public-to-private buyouts represent a smaller fraction of activity now compared with during the 1980s. On the other hand, **Divisional Buyouts** and **Secondary Buyouts** have increased in importance over time.

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In recent debate, many have argued that private equity funds have become more and more short-term oriented, preferring to quickly “flip” their investments rather than keeping their ownership of companies to fully realize their value potential. As per WEF analysis, there is no evidence of “quick flips” (i.e. exits within 24 months of investment by private equity fund) becoming more common. On the contrary only 12% of deals are exited within 24 months of the LBO acquisition date.

Many Portfolio firms remain in LBO status even though the original LBO sponsor has exited. The holding periods of LBO firms are remarkably long. The median firm remains in LBO status for more than nine years and only 17% of firms exit LBO status within three years of the original LBO transaction. In addition, holding periods seem to have increased over time. The median firm undergoing the original LBO in the 1980s exited LBO status after 6–7 years, while the median LBO firm in the 1995–1999 period exited after nine years.

As per the WEF study, the most common exit route, for private equity and management buyout deals alike, is trade-sales to another corporation, accounting for 39% of all exits. The second most common exit route is secondary buyouts (24%), which have increased in importance over the last decade consistent with anecdotal evidence. In contrast, IPOs only account for 13% of exits and this exit route seems to have decreased in relative importance over time. Around 6% of all leveraged buyout transactions end in bankruptcy or financial restructuring.

As per The Wall Street Journal, with the prices of existing loans tumbling, investors have little incentive to buy new loans unless they are sold at steep discounts, something banks are reluctant to do." JPMorgan held \$26.4 billion in LBO loans in Dec '07. Other large banks probably have similar amounts on their balance sheet. Many of these will be sold for 90 cents on the dollar, if they get sold at all.

## **1.2. ECB Survey**

The ECB survey identified the key risk for individual banks as being caught with a large exposure (for example, a bridge loan) when an LBO deal fails prior to distribution. Failed syndication may leave the bank with very large and concentrated exposures to individual names that it was not intending to hold beyond the short run. In such cases the originating bank could become exposed to a potentially very large credit loss and, via expectations, broader market confidence could be hit. The role of failed syndications or prolonged syndication times as a key indicator of potential problems in the LBO market is further enhanced by the dilution of the role of loan covenants as early warning indicators. The EU survey results suggest a growing tolerance for covenant breaches and a tendency towards fewer covenants being included at the outset in new deal contracts.

Banks' exposures to LBO activity are, however, not limited to credit risk. The EU survey revealed that many banks are earning substantial income from the investment, fees and commissions derived from LBO-related activities. (Standard and Poor's estimates that in the US, bank fees from leveraged finance activity grew by nearly 90% from 2000-2005

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while in the same period corporate and investment banking fees grew by 12%. According to S&P, these figures are likely to grossly underestimate the true fees. For every dollar of leverage finance fees they earn from LBO transactions, banks could earn an additional 40-80 cents from related product sales. The opportunity to access such revenues has attracted new entrants to the market and encouraged existing players to expand their activities. The growing reliance by some banks on fee and investment revenues from LBO financing suggests that any slowdown in the market could substantially hit these institutions' income streams.

Intense competitive pressure to win new deals, compressed margins and acceptance of weaker covenant clauses as a result of optimistic expectations on future economic outcomes could make the LBO market both more risky and less profitable for banks in the future. ECB report suggested that all these factors stressed the importance of rigorous risk management techniques and large-scale application of stress-testing in banks. Such stress tests should include scenarios of adverse interest rate movements (due to future refinancing risks) and they should extend to horizons that are consistent with the maturity of the non-amortising loan structures. Appropriate stress-testing should be applied both during deal selection and post-closing monitoring periods. There is no margin for complacency on this matter, as it is unlikely that the various risks identified would, if they were to crystallise, surface individually or isolated from one another.

In the EU market Net interest income represented on average 42% of LBO income for Portfolio banks, followed by equity returns (32%), which reflects the importance of equity investments in LBO transactions among Portfolio banks. Differences between business models become more obvious when these results are contrasted with the distribution of LBO-generated income by Capital Turnover banks. According to the survey replies, for this class of banks the bulk of the LBO-related income was derived from arrangement and distribution fees (on average 40%), as well as corporate finance and advisory fees (on average 22%). Indeed, a few banks derived more than 70% of LBO-related income from corporate finance and advisory fees as of June 2006. Interest income also proved to be important for some banks within this class which tend to combine features of the balanced model (i.e a mixture of both Portfolio and Capital Turnover model). Income from equity investment represented on average only 10% of the LBO income of the Capital Turnover banks for which this information was provided.

In EU in 2006, bank debt remained the main source of funds for LBO transactions, accounting for half of total LBO proceeds. The bank loan structure of LBO transactions in Europe may, however, still be regarded as fairly conservative. In fact, senior tranche A debt accounts for around 23% of the total bank loan structure – a considerably higher share than in the US market, where senior tranche A debt accounts for merely 0.8% of the total bank debt to LBOs. The strong competitive pressure in the EU's LBO market has increased the risk appetite of potential creditors, as manifested by the increasing proportion of riskier debt in LBO transactions.

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Besides issues associated with micro risk management at the level of individual banks, other identifiable sources of risk can be linked to the possibility of adverse market moves as described below.

– The growing interrelationships between financial markets (debt, equity, derivatives, etc) create new channels of contagion through which liquidity problems may propagate (as evidenced by the recent crisis). Indeed, the ability of banks to remain active in the LBO market (i.e. distributing a large share of credit risk to other players) relies heavily on the resilience of institutional investors' demand as well as on the effective functioning of the credit risk transfer markets.

– While the growing importance of the institutional investors as debt buyers has, up to now, permitted the LBO market to grow steadily by spreading risk more widely among the various entities in the financial system, there are risks that this source of liquidity could prove fickle. For instance, investors' appetite for risk could prove volatile should conditions in the global economic environment deteriorate (as it has been happening now).

– Changes to the loan market structure, including weaker covenants, the move to non-amortising structures, and a rise in "Equity Cures" which allow private equity sponsors to inject equity to avoid covenant breaches, may make it harder to tell when the LBO market is entering a difficult phase. From this point of view, it cannot be excluded that the current market assessment of the strength and resilience of the LBO market is somewhat biased as the availability of equity cures and existing incentives for investors to avoid complex workouts may temporarily help in hiding or postponing existing problems.

WEF study does not find much evidence that the growth of private equity has been at the expense of public stock markets, however. Among firms entering LBO status over the 1970–2002 period, the fraction of firms exiting LBO status by going public was 11%, which is substantially higher than the fraction of LBOs that originated from going-private transactions, which was approximately 6%. In other words, the flow from private to public equity markets is net positive over the long run. LBOs in economies with less developed financial markets are particularly likely to eventually go public, which suggests that private equity can play a role in promoting stock markets in these countries.

The EU Survey results indicated that banks do not seem to be regular equity capital providers in LBO transactions. In fact, this type of equity exposure was seen to be far less relevant for banks than debt exposures. Total equity exposures of EU banks were close to €12 billion in June 2006, both in terms of paid-in and committed capital, contrasting with a figure of almost €100 billion for debt exposures. Equity-providing EU banks showed a clear preference for investing in single GP/manager LBO funds (as opposed to funds of LBO funds).

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## **Australia**

In Australia and in some other countries, governments impose restrictions on when, and the extent to which, interest can be claimed for tax deduction purposes. These rules are intended to ensure that foreign companies do not allocate an excessive amount of debt to their host country PE operations, and thereby derive excessive interest deductions. Put simply, under these rules, interest payments arising from debt-to-equity ratios that exceed a ratio of 3:1 are not tax deductible. The rules do not impose a limit on gearing; rather, they impose a limit on the extent to which the interest on debt is tax deductible.

A Senate Standing Committee on Economics in Australia mentioned that a study was done to find out the tax implication on the Australian economy if five of the Australia's biggest companies (namely Coles Myer, Tabcorp, Woolworths, Qantas and Westfarmers) were taken over by US PE firms through LBO deal. Two different studies estimated that the loss in corporate tax to the Australian exchequer because of these deals could well be, \$1.2 billion and \$918 million per annum respectively as a result of interest resulting from increased debt being claimed as a tax deduction.

## **Japan**

In Japan, various changes in legislation in recent years provide a mechanism to tax private equity profits on exit from their investments. The so-called "Shinsei tax" levies a 20 percent tax on sales of investments by funds, a measure that was prompted in part by the exit of a consortium of private equity firms from the former Long Term Credit Bank, which the consortium bought out of receivership in 2000. Renamed Shinsei Bank, the bank was sold in 2005 for more than four times the original investment, with no local tax payable. Such exits would now be subject to tax, although US-based funds may not need to pay because the Japan-US tax treaty gives them protection in certain situations. (KPMG)

In some cases Sovereign Wealth Funds (SWFs) have started investing in Private Equity deals e.g. China Investment Company Ltd.'s USD 3 bn. investment in Blackstone Group. As like any other PE firms, SWFs also do not have to face scrutiny due to lack of publicly available information. This has raised doubt in many Governments that these investments made by SWFs are more for political and strategic reasons rather than for financial gain.

## **Likely regulatory initiatives in future**

The "Group of 30", an international committee of current and former senior regulators and bankers – released 18 recommendations for reform of financial market oversight.

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Recommendation #4 is titled “Oversight of Private Pools of Capital” and calls for registration and regulation of managers of leveraged investment pools. A few of the new proposed obligations for the Fund managers which the recommendations are likely to entail are given below:

- (i) In the US the relaxation given to few fund managers by allowing them not to register with SEC is proposed to be done away with. The fund managers managing funds of almost all sizes (barring a few with handful of clients or very small fund) may be required to get registered with SEC. PE fund managers are also likely to be included in this.
- (ii) There should be ongoing reporting obligation for almost all the Fund Managers in respect of information regarding size, investment style, borrowing and performance to find out whether there is any mispricing, liquidity concern, lack of diversification, and deviation from stated investment objectives. Some of these disclosures may be made public as well.
- (iii) The Group of 30 Report refers to establishing “appropriate standards for capital, liquidity and risk management – at least for funds above a particular size judged to be potentially systemically significant.”
- (iv) The Report revives the idea, of a “re evaluation” of fund investor suitability standards.

## **2. Indian Scenario**

### **2.1 Regulatory Framework for VCFs**

In India, the VCFs are regulated in terms of provisions of Securities And Exchange Board Of India (Venture Capital Funds) Regulations, 1996. However, majority of VCFs in India are unregistered. Main provisions of SEBI regulations governing investment activity of VCFs are as under:

- (i) No venture capital fund set up as a company or any scheme of a venture capital fund set up as a trust shall accept any investment from any investor which is less than five lakh rupees
- (ii) Each scheme launched or fund set up by a venture capital fund shall have firm commitment from the investors for contribution of an amount of at least rupees five crores before the start of operations by the venture capital fund.
- (iii) All investment made or to be made by a venture capital fund shall be subject to the following conditions, namely:—

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- (a) venture capital fund shall disclose the investment strategy at the time of application for registration;
  - (b) venture capital fund shall not invest more than 25% corpus of the fund in one venture capital undertaking;
  - (c) shall not invest in the associated companies; and
  - (d) venture capital fund shall make investment as enumerated below :

- (i) at least 66.67% of the investible funds shall be invested in unlisted equity shares or equity linked instruments of venture capital undertaking.

- (i) not more than 33.33% of the investible funds may be invested by way of:

- (a) subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed;

- (b) debt or debt instrument of a venture capital undertaking in which the venture capital fund has already made an investment by way of equity.

- (c) preferential allotment of equity shares of a listed company subject to lock in period of one year;

- (d) the equity shares or equity linked instruments of a financially weak company or a sick industrial company whose shares are listed.

- (e) Special Purpose Vehicles which are created by a venture capital fund for the purpose of facilitating or promoting investment in accordance with these Regulations.

## **2. 2. Banks' investment in VCFs**

### **2.2.1 AMCs managing VCFs sponsored by banks**

As of December 31, 2008, there were 115 VCFs sponsored by banks. Of these VCFs, in 90 VCFs banks' share in the corpus was less than 20%. Only in 5 VCFs, banks had invested in more than 50% of the corpus. These VCFs (115) are managed by 19 AMCs. Of these, number of AMCs in which banks had held less than 20%, 20-50% and more than 50% equity were 2,1 and 16, respectively.

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## 2.2.2 Banks' investment in VCFs

As on December 31, 2008 banks' investment in PE funds was as under:

(Rs.in cr)

Public sector banks	3525.07
New Private sector banks	10900.80
Old Private sector banks	22.25
State Bank India Group	421.17

**Annex 3**

### **Generic Risks in PEF Business**

#### **1. Inherent risky nature of investments**

- (i) The investors in a PE deal are dependent on macroeconomic or systemic factors which are beyond their control. It may so happen that on their part, the



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investors do everything right and manage the portfolio company very well to command a good return their investments. But if the macroeconomic/financial situation worsens subsequently, then the investors will find their fund locked in. At the same time, the prospect of fetching good returns also becomes very bleak. Particularly, during economic/financial downturns, mobilising investments and arranging debt becomes very difficult for the AMCs/General partners(GPs). If an investors promises certain amount of investment in a PE fund, subsequently the macroeconomic scenario worsens; it may not fulfil its promise and put the Fund in a difficult position. During bad times, some of the investors may even sell their investments in a PE fund at a discount which does not augur well for the rest of the investors, the GP and the debt providers in the deal/fund.

- (ii) These investments are illiquid, as they cannot be readily bought or sold the way registered shares of a publicly held company can be. The investments are typically held for the intermediate to longer term in the expectation of higher returns for higher risk.
- (iii) The investments are inherently risky as these are generally made in higher risk companies, such as start-ups, leveraged buy-outs, or similar investments.
- (iv) Other inherent risks for private equity investors include, overvaluation of portfolio companies, high expectations by investors for income and growth versus current prospects, competition in a global economy, and compliance with regulations e.g. Sarbanes-Oxley regulations (in case of USA).

## **2. Risks arising from LBO activity**

PEFs generally engage in LBO activity. They fund the acquisitions with bank loans thus making the financial performance of the PEF highly sensitive to volatility in the earnings. According to the preliminary data released by European Private Equity and Venture Capital Association on March 12, 2009<sup>v</sup>, based on private equity fund performance over the past 29 years and a sample size of 1,310 funds, the Net internal rate of return (IRR) since inception to December 2008 was +10.3% for all private equity, with buyout funds returning +14.2% and venture funds returning +3.1%. The Press Release noted that the macro-economic volatility over the past year caused a slump in short-term horizons of -24.9% for all private equity, including -17.9% for all venture and -26.4% for all buyouts. Within the buyout segment, mega buyout one-year horizons fell to -27.1%, compared with +20.1% in 2007. Small buyout fell from +39.5% in 2007 to -23.8% in 2008. Mid-market buyout fell from +25.2% in 2007 to -17.9% in 2008. These data indicate extreme sensitivity of the PEF earnings to the macro-economic environment.

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### **3. Competition from other hedge fund**

The private equity industry has been particularly affected in recent years by the encroachment of hedge funds, attracted to private equity by strong returns, especially over the past three years. Shorter term strategies of hedge fund managers, combined with their shorter-term fee structures, potentially clash with the typically illiquid nature of private equity funds. Hedge funds have both competed with private equity funds and played complementary roles, as when hedge funds serve as sources of debt capital, potential acquirers of portfolio company assets, or investors in various transactions<sup>v</sup>.

Competition among lenders to provide funds to the leveraged finance industry has increased leverage ratios, driven down borrowing costs, and loosened terms. The growing role of non traditional lenders, such as hedge funds, has ratcheted up competition.

### **4 Erratic return**

The returns generated by PEFs are more volatile than that of many other asset classes. Many banks have recently exited the private equity business (as GP/LPs); mainly because its volatile returns are ill-suited to the steady consolidated returns favoured by bank shareholders.

### **5. Regulatory arbitrage**

Banking organizations engaging in private equity activities face special compliance challenges compared with their nonbanking competitors. In USA, it is noted that greater supervisory oversight since the enactment of GLBA (Gramm-Leach-Bliley Act ) has brought many benefits to financial holding companies, including closer integration of compliance functions with private equity business lines, independent reviews of valuations, and greater transparency and oversight of the business. But this can be taken as blessing in disguise as well for the bank holding companies as this will increase the level of corporate governance in these institutions. On the other hand as

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many of the PE funds are set up as Limited Partnership companies the regulatory, disclosure and compliance requirements are much less.

More importantly, in some countries (especially in the US) most PE firms enjoy the benefit of being a Limited Partnership company in terms of tax obligation as well. The profit earned by them is taxed at 15% i.e as applicable for capital gains tax in the US. On the other hand if banks set up a PE firm as their subsidiary then the tax on profit will be as per the corporate tax rate i.e around 30%

## **6. Conflicts of interest**

From governance and litigation standpoint, concerns over conflicts of interest in case of PE transactions have been of high importance. PE transactions, in many cases, will try to align the management team of the portfolio company, with the acquirer. This may not be conducive for critical evaluation of the strategies suggested, hard negotiation on behalf of the portfolio company and maximising original shareholders'(of the portfolio company) value.

The following areas may be potential areas of conflict in a PE deal, though there can be many other areas of conflict depending on the nature of the deal.

- One of the areas is the conflict of interest among the existing shareholders and management (and directors) of the portfolio company. PE acquisitions generally maintain the status quo in regards to management of the portfolio firm. The management of the portfolio co. may be lured by the PE firm by the promise to receive part of proceeds from the sale of equity of the portfolio company, stock options in post merger entity, enhanced performance incentive, prospect of enormous windfall in case of recapitalisation or public offer again. Shareholders of the portfolio co. feel that while approving the deal in favour of a PE transaction (and not in favour of a strategic acquisition), the management and Directors might have been influenced by the enticements promised by the PE firm. Also, regarding the selling price the existing shareholders eventually get, there is doubt whether price was negotiated in the best interest of the existing shareholder or lopsided to the PE firm because of the self interest of the management or directors of the portfolio firm.
- Secondly, regarding the decision given by the financial advisers (appointed by the management of the portfolio company, engaged in analysis of the economic

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fairness of the transaction, a doubt is cast whether the decision given by them, was influenced by their compensation being dependent on their favourable decision towards the PE deal<sup>v</sup>.

- Another potential conflict of interests between the GP and LPs may arise if GP wants to reinvest the profit/dividend income again in the portfolio company. This will help the GPs to have a higher income because of more assets under management. But the LPs will feel they are on the losing side in terms of immediate return and liquidity.
- As the capital brought in by the GPs are miniscule (around 1% of the fund) compared to that of LPs, the later have a feeling that GPs are always taking more risk.

## **7. Corporate Governance Issues**

Corporate Governance, in the recent time has hogged much lime light in respect of Private Equity firms, Portfolio firms and interrelation between these two. Below we discuss a few important areas pertaining to corporate governance in Private Equity transactions<sup>v</sup>. But before discussing these issues we have to keep in mind that most PE firms are in the form of Limited Partnership, hence institutionalized forms of corporate governance comparable to large public companies are rare. The relationship between investors (LPs) and manager – General Partner (GP) of a PE firm is governed by a partnership agreement which states the rights and responsibilities of each party. Given the legal structure as partnership most private equity firms do not have supervisory board. However, some organisations adopt governance principles by establishing certain advisory and control committees, driven by pressure from institutional investors.

- To avoid asymmetry of information among GP and LPs, there should be information sharing on a regular basis in terms of reports, meetings among the partners.
- LP presentation should be a must in committees formed by PE firms to look into (and give consent to) the critical decisions (e.g excess exposure to a single company), that circumvents the initial partnership agreement.
- The level of direct involvement of PE firms in their portfolio companies raises eyebrows sometimes. In some cases PE firms replace or add to the existing

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management team of the portfolio companies and bring in their own employees. PE firms also get engaged in variety of management aspects including recruiting, compensation of key managers, decisions involving M & A. Though, transparency and reduction of information asymmetry are cited as reasons for these, one cannot ignore the corporate governance angle attached to it.

- In order to align the interests of the executive management of the portfolio firm with that of the PE firm, a substantial portion of senior management compensation is normally structured as performance based so that the value of the PE investments keeps appreciating.
- At a time when a PE firm wants to exit from a portfolio firm, the exit process can potentially lead to conflicts between executive management team of the portfolio firm which is supposed to stay with the business, and the PE investor who want to end relationship with the same business. While the PE firm's objective is to maximise value while selling a business, managers of the portfolio firm might have certain preferences regarding the timing or also the choice of the disinvestment mode. Mostly, executives and managers of the portfolio firms prefer a public market exit to a sale to a competitor firm because of apprehensions related to prestige, job cutting, personal career apprehension in case of senior managers etc. Maintaining a balance between various interests is crucial function related to corporate governance.

## **8. Reputational Risks**

Five key areas have emerged as the most significant threats the PEF industry faces to its reputation<sup>v</sup>:

### *(ii) Regulation*

All over the world various regulators/social activists/governments are leading a vigorous campaign for private equity firms to be regulated by a tough watchdog which will take into account the social and economic impact of private equity takeovers. The regulator will be paying particular attention to any potential market abuse and conflicts of interest.

### *2. Legislation*

Although the workers unions resent the way some private equity management teams treat their workers, at the heart of their concerns is the favourable tax regime enjoyed by executives and managers. Such perceptions increase the problems for the PEF firms.

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### 3. Failure

Failure of a PEF where pension funds have invested would attract severe negative criticism from public.

### 4. Job cuts

In many cases the takeover are flowed by a series of job cuts which cause union fury. This leads to relentless union campaign.

### 5. Negative Media perception.

Recently, the PEFs have been referred to as to as everything from “rodeo capitalists”, “locusts”, and “bog snoopers” by the Press. In particular, the reputational risks for the PE firms have grown with some unfavourable publicity. Some private equity firms are alleged of taking exorbitant advisory fees from newly acquired portfolio firms and burdening them with heavy debt loads, as well as engaging in other unsound business practices, such as inadequate disclosure, questionable accounting. Experts in USA suggested that one way for the industry to counter these perceptions would be to voluntarily implement certain governance requirements of the Sarbanes-Oxley Act of 2002, such as those relating to codes of ethics, audit committee independence, and financial statement accountability.

## 9. Other risks

In addition to the above a few more areas of concerns may be pointed out resulting from PE deals as given below, although these points may not be unanimously agreed upon.

### (i) Unclear ownership of economic risk

The duration and potential impact of any credit event may be exacerbated by operational issues which make it difficult to identify who ultimately owns the economic risk associated with a leveraged buyout (and subsequent secondary market deals involving instruments originating from LBO deals) and how these owners will react in a crisis (Very same risk as found in the originate to distribute model in subprime crisis).

Financial institutions originating the bank loans that were financing the vast upsurge in private equity deals were not retaining these loans on their own books, but rather were syndicating them and selling them into the secondary market. Because the originating banks were realizing large fees upfront and then reselling these securities to third

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parties, the originating banks' incentives to carefully assess the risks of each loan, to screen out weak applicants and to monitor their ongoing health were significantly weakened. This created incentives for excessive risk taking in the LBO market. Compounding this problem, many of these deals used "covenant lite" debt, whereby, because of highly competitive credit market conditions, LBO lenders agreed to accept weaker contractual protections that reduced lender abilities to constrain or discourage opportunistic managerial conduct at these newly privatized firms.

(ii) Reduction in overall capital market efficiency:

In the developed countries, substantial inflows of capital into PE funds combined with the considerable appetite of the debt market for leveraged finance products are fuelling a significant expansion of the private equity market. The quality, size and depth of the public markets may be damaged by the expansion of the private equity market. An increasing proportion of companies with growth potential are being taken private and fewer private companies are going public (as a consequence of the development of the secondary private equity market). Also, the growth potential of those companies that do go public may already have been fully exploited.

(iii) Market abuse

The significant flow of price sensitive information in relation to private equity transactions may create considerable potential for market abuse. This flow increases as the complexity of the transactions grows and more parties become involved. The involvement of participants in both public and private markets and the development of related products traded in different markets, e.g. CDS (Credit Default Swaps) on leveraged loans, increase the potential for abuse.

(iv) Market opacity: In PE deals, although transparency to existing investors is extensive, transparency to the wider market is limited and is subject to significant variation in methodology (e.g. for valuation, fee disclosure etc) and format. This makes relative performance assessment and comparison complex, which might have deterred investment by various professional investors who may not be comfortable interpreting the information. It could also lead to ill-informed investment decisions by such investors.

## Annex 4

### Risks in LBO Finance

Three phases are relevant in assessing the actual risk exposure of banks underwriting LBO transactions, and these are: **Commitment in-principle**, **Legal Agreement** and **Full Documentation (or finalisation) Date**. The process starts when a bank commits

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“in principle” to provide the finance, and should the bank step back from this commitment its **reputation** might be damaged. However, there is no legal obligation to participate in the transaction. The next step is the finalisation of a firm legal agreement by which a bank is legally required to provide the finance. The latter date refers to the point at which the transaction is finalised (documentation), signed and the cash transfer occurs. **Syndication** can only begin once the transaction is finalised. Specifically, due to the time lag between the final commitment to the deal and the ending of the syndication process, arrangers of syndications are exposed to underwriting risk until the syndication is settled. To partly mitigate the underwriting risks it is not uncommon for the LBO sponsors to invite several banks at an early stage to provide the leveraged financing for a specific deal, in which case the pre-syndication exposures will already be a fraction of the total value of the prospective deal.

The execution timeframe between commitment to the deal “in principle” and completion of the full documentation is important. Indeed, the greatest risk for banks occurs between the date of commitment to provide the leveraged finance and the date at which the transaction takes place, as typically distribution can only start after the formal transaction completion date. Any disturbances to the market at this time could result in difficulties in passing on the credit risk.

Due diligence, credit analysis and the ability to syndicate and distribute credit risk are key elements in banks’ assessments of the risks associated with LBO lending. Most banks involved in the EU survey perceived LBO financing to be riskier than other types of corporate lending, due to the higher leverage involved. The credit analysis of LBO deals tends therefore to be at least as extensive as in the case of the banks’ other corporate lending decisions. Some banks explicitly require that LBO deals are subject to a higher degree of credit analysis and due diligence than other lending. Banks that arrange syndications typically carry out their own due diligence. For banks participating in syndications the picture is more mixed: some banks rely on internal due diligence, while others rely to a greater extent on external due diligence. However, all participating banks carry out their own credit analysis, motivated by the fact that this aspect of risk management is considered too important to be left to others.

Another important aim of the credit analysis is to assess banks’ ability to syndicate and distribute risk exposures down to comfortable levels. Most banks involved in the EU survey have emphasised that LBO transactions expose them to high concentrations of credit risk to one counter party. Therefore, the vast majority of banks aim to reduce their exposure towards single names to a preferred level by distributing debt to other banks and to investors in the secondary market. Indeed, most banks involved in the survey perceive the underwriting risk – i.e. the concentration risk that arises within the execution timeframe – as being a major risk in providing LBO financing. Therefore, the ability to mitigate underwriting risk also forms an essential part in most banks’ decision-making process. Therefore, the possibilities for distributing risk are assessed and the residual concentration risk is taken into account by banks before they make the final commitment to a deal.



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Banks can use additional instruments to reduce risks associated with LBO lending. Up to the documentation and syndication phase, market-flex clauses provide an opportunity for arrangers to reduce the underwriting risk by allowing them to make subsequent adjustments of the credit terms to current market conditions. After the syndication is completed, MAC (Material Adverse Change) clauses still allow for modifications to pricing or structure of the debt depending on market conditions. Credit derivatives provide further opportunities to mitigate banks' exposure. However, the extent to which banks use these financial instruments to reduce exposures varies considerably. While **credit derivatives are barely used in some EU** countries, large players in particular assert that their presence in the LBO market is entirely conditional on access to hedging by credit derivatives.

The valuation of collateral is generally a part of bank's credit analysis process. Banks attempt to achieve as perfect a security structure as possible, but recognise that there are restrictions on acceptable collateral in LBO transactions. Such restrictions include the distinct legal environments in different geographic markets, the structure of the deal and the quality and negotiating power of the LBO fund counterparty. A stronger debtor negotiating position may force the banks to accept weaker covenants and lower-quality collateral, which reduce the recovery ratios in distressed situations.

It is important to stress that most banks consider collateral values to be of secondary importance to the target company's ability to generate cash flows to repay its debt. This is often due to the difficulty banks have in setting a reliable value on the target company's assets. The collateral for the senior debt tranches generally consists of the target company's securities, the market value of which can be volatile and uncertain. Therefore, banks typically require a big haircut to collateral values to ensure sufficient cover. In this respect it is revealing that most banks – even though their lending to LBO deals is secured in principle – treat their LBO exposures as unsecured by attaching zero weight to the collateral they hold.

Typically, banks set covenants for the quantitative ratios of the portfolio companies and monitor these closely on a timely basis. Banks review the financial performance (returns, cash flow generation and financial ratios) of the business against the original covenants together with a review of the cash flow models and ratings. However, in case banks suspect adverse credit deterioration, exposures are then reduced via secondary markets for debt investments. In benign market conditions, such sales of "problem exposures" encounter few difficulties because of the high market liquidity and enormous demand for LBO debt instruments. Although this is beneficial for banks' risk management, it may mask the build-up of problems in the LBO market which could ultimately be revealed if market liquidity was sharply reduced.

Banks' investment exposures, inter alia, include possible equity investments in LBO/Buyout funds, and Co investments. Banks may invest in LBO/Buyout funds managed by the bank itself (or its affiliate) or by an unconnected management firm. The main risk involved in these operations is the under performance of the equity, which

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however is reliant on the competence of the individual equity sponsor (i.e GP in case bank has not set up the PE firm)) rather than the banks. For this reason, banks need to constantly monitor their equity exposures as well as the performance of the equity sponsor. Some banks prefer to conduct this type of operation with sponsors/GPs with whom they have an already well established relationship as this may enhance the information flow and facilitate monitoring.

The primary risk management tool applied by banks to reduce their exposures to lending to LBO activity is the distribution of credit risk among other banks and more broadly in the financial system via securitisation and the secondary loan and credit derivatives markets.

The emergence of the secondary market for LBO loans is an important development that increases the exit options for LBO investors, adds to the liquidity in the market and also provides forward-looking indicators regarding the sentiment in the LBO marketplace. At the same time, however, the transfer of LBO loan tranches to third parties has blurred the identity of the end-holders of credit risk. The rapid growth in the market for credit derivatives in particular, while successfully contributing to a distribution of risks across markets and across financial and non-financial agents, raises the question regarding the robustness of the (mostly OTC based) market for credit risk transfer. Investors, creditors and debtors who are active participants in LBO transactions and who hedge their positions extensively by using credit derivatives products should therefore be fully aware of the risks they may have assumed – such as risks of disruptions in the credit risk transfer market infrastructure or hidden counterparty risks. A related risk that arises from the combination of the introduction of complex leveraged loan products and the activity of lightly regulated institutions in the marketplace is that the overall exposure of some investors to riskier parts of the LBO debt structures could be considerably higher than could be inferred from their balance sheets. For example, some leveraged investors, such as specialised hedge funds, may have exposures to deeply subordinated leveraged loans by their positions in leveraged instruments such as junior CLO tranches. To account for such “embedded leverage”, frequent review of counterparty exposures is a crucial task particularly for those banks that distribute large shares of their LBO debt exposures. Such ongoing monitoring is important even if retained LBO-related exposures are placed in the trading books where they are subject to marking-to-market.

By nature, LBO deals tend to be aggressive as regards both pricing and leverage. However, diversification, or syndication of exposures among different types of investor effectively mitigates banks’ credit and concentration risks, with banks typically ending up holding the less risky senior debt tranches. Moreover, as long as a liquid secondary market exists for both deals and debt, banks’ liquidity risks are likely to remain relatively limited.