Annexures

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Annexure – I

(see para 1.4, 10.2.1, 10.2.2.7)

Presentations given by outside organisations to the In-house Working Group

SBI Capital Markets Ltd.

1. Smt. Rupa Devi Singh, Vice President & Group Head, Financial Engineering, SBI Caps gave a detailed presentation covering the Indian experience in contrast to the ground realities in some of the developed countries. The various hindrances faced by SBI Caps in their attempt to structuring securitisation deals were explained at length. She stated that officials from SBI Caps along with NHB had visited USA in 1994 to get a feel of the securitisation process and interact with various agencies engaged in securitisation. She explained the intricacies pertaining to treatment of receipts as equity by the Originator out of the sale proceeds. She stated that there were difficulties in creating a trust as the existing legal and other environment are not conducive for trusts to come into being. She also informed the Group that Ashok Leyland and Tata Finance were active in this field among NBFCs. She stressed the importance of securitisation as this instrument is destined to play a leading role in funding long term assets of say, 15 years maturity. She informed the Group that Institute of Chartered Accountants of India (ICAI) are yet to issue suitable guidelines for securitisation although SBI has already written to them. She explained the difference between Pass Through Certificate and Pay Through Certificate. She pointed out that while an umbrella legislation could be considered in the long run, minor amendments to some legislation and issuance of clarifications for the present, will facilitate the promotion of securitisation in the short run.

National Housing Bank (NHB)

2. Shri R.V. Verma, General Manager, NHB informed the Group that NHB has acquired vast experience in mortgage securitisation in recent years and has reached an advanced stage of preparation for launching the securitisation product in a big way. Shri Verma spoke on securitisation of mortgage loans and operational and regulatory issues. He informed the Group the huge funds requirements (Rs.1,50,000 crores during current five year plan) and the constraint of the meeting these requirements through either budgetary allocation of Government or normal credit flow of the banking sector. He stated that housing finance institutions have reached a stage where they can go direct to the market without the intermediation of banking institutions. He explained how supply of funds to the mortgage market through securitisation could lower the interest rates on mortgage loans. Long term debt market can be facilitated through introduction of mortgage backed securities (MBS). He explained how the regulatory, promotional and

financial roles of NHB are mutually synergic. While the regulatory role gives an opportunity to have on site supervision and off-site surveillance, the information can be gainfully utilised to promote research, analysis of past performance and the behaviour of various classes of mortgage loans. These can lower the yield on securitisation paper and increase the spreads. He suggested that a beginning could be made by securitising loans of individual housing finance companies followed by pooling of portfolio of different housing finance companies. He informed that Ninth Five Year Plan had indicated resources mobilisation to the extent of Rs.2,500 crores through securitisation. There is growing gap between the demand and supply of houses. The current environment of deregulation can be capitalised upon by introduction of an active secondary mortgage market. NHB had taken up the matter of securitisation with State Governments through Ministry of Urban Development. Simplified foreclosure laws are attracting the attention of the Government. This, coupled with mortgage insurance can improve the competitiveness of securitised instrument. Through securitisation, funds can be channeled into housing sector through MBS. He also impressed upon the need of implicit guarantee of the Government to the MBS issue of NHB. He indicated that 'cherry picking' would be required in the beginning. This may give incentive for quality portfolios, standardised documentation etc. He pointed out the need of adequate disclosures in the offer document regarding the items/ rights where recourse is available and items/ rights where recourse is not available. He also highlighted the pool selection criteria evolved by rating agencies in association with NHB which included unencumbered loans, lending to individual for residential houses only in the State of Maharashtra, Tamil Nadu, Gujarat and Karnataka with maximum loans to value (LTV) of 80 per cent. Joint loans with other lending institutions are to be excluded. The recourse to the Originator in the form of cash flow is limited to the cash pool set aside for these purposes by the Originator. He highlighted that pre-payment risk and default rik beyond credit enhancement in Pass Through Certificates will have to be borne by the investor. He also suggested that investment in MBS by banks should be (i) treated as priority sector lending, (ii) included in the allocation of the banks for housing finance and (iii) given 20% risk weight as in the case of investment of bonds of NHB.

ICRA Ltd. (ICRA)

3. Shri Naresh Takkar and Shri Basu of ICRA gave the presentation on 'Structuring and Assessment of Credit Risk of receivables – System requirements'. The presentation covered the assessment of credit quality risk, structural and legal regulatory issues and system requirements from Originator point of view. The rating measures ability and willingness of the structure to sustain all repayment obligations (cash flows) over the currency of the transaction. Shri Basu explained the difference between traditional MBS/ABS, Collateralised Debt Obligations (CDO) and future receivables. In India, recent innovations include housing finance receivables, electricity receivables, school fees, future collections by builders, ticketing receivables by Air India etc. Large issues are not rated and are placed privately under bilateral arrangements. Shri Basu informed that there are Standby Administrators and Standby Trustees in the USA, which can be inducted if investors feel so. Credit enhancement bridges shortfalls in cash flows from time to time. He also pointed out that SPV could be tax neutral in case of Pass Through Certificates and tax assessable in case of Pay Through Certificates. In the process of risk assessment, the rating agencies undertake actuarial exercises to ascertain the probability of default. In the Indian scenario, very little information is available on the demographic characteristics of the pool of assets except for the data on income level of Obligors. Different

geographical locations can have influence on the actuarial assessment (better quality assets in western and northern zones while the assets in southern part of the country have erratic behaviour). The nature of asset (e.g. ordinary / luxury car, heavy duty / light duty vehicle) also influences the level of credit enhancement. Credit enhancement is linked to targeted credit rating, which need not be 'AAA' in all the cases. In the payment mechanism, the Obligors make payments to the Originators even after securitisation. The re-investment risk in pay through structure can be minimised through investment in safe Government of India securities instead of securities of State Government / municipal bonds. In the case of third party guarantees, the credit risk is to be evaluated. In case of the floating rate instrument, benchmark rate and frequency of monitoring are important structure issues. The clarity of the definition of the roles of Originator, SPV and Servicer are other important determinants. He also elaborated the SPV structure in the form of Corporate or a Trustee. In the case of a Trust, although it is easier to create the entity, the investors have the right to seek even the minutest details of the underlying Obligors. He also stated that the nature of issue Pass Through Certificate, bonds or debentures is a grey area. He also informed that there was a ceiling of 10 per cent credit enhancement in USA till recently. On the subject of other legal and regulatory issues, Shri Basu opined that the notification to the Obligor is not required under the Indian laws. He also stated that call option for Originator (repurchase obligation of the Originator) is not allowed.

ICICI Ltd. (ICICI)

4. A team of four officers from ICICI gave the presentation on 'Securitisation: Steps to be taken to initiate the instrument in India'. The presentation included assignment process, the structure of SPV, nature of securitised instruments and other issues. It was explained how Order II, Rule 2 of Code of Civil Procedure 1908 prohibits part assignment. Section 5 of Transfer of Property Act, 1882 states that the property being transferred must exist in present and prevents transfer of future receivable. Further, the high stamp duty ranging from 4 to 10 per cent in many States also needs to be exempted/ minimised for securitisation transactions. Under the Income tax Act (Section 60) transfer of income without transfer of underlying assets keeps Originator liable to taxation. Section 63 of the Income Tax Act, involving transfer of beneficial interest without transfer of legal interest, makes transferors liable to taxation. Section 10 (23G), which gives benefit of investment in infrastructure bonds, should be made applicable to securitisation debts representing loans for infrastructure developments. Regarding SPV, it was stated that it should achieve –

- ❖ Bankruptcy remoteness
- ❖ Tax efficiency
- ❖ Capability to issue publicly traded paper

Out of the various forms of SPV as Company, Trustee and Mutual Funds (which is not subject to taxation), the Mutual Fund (MF) is most suitable immediate remedy. A point was raised whether MFs can issue securities with assured returns. This may have to be examined in detail at a later stage. It was also pointed out that Regulation 43 of SEBI (Mutual Fund) Regulations 1996, needs clear definition of securitised debt. Second proviso of Regulation 43 ibid excludes investment by MFs in MBSs. This needs to be deleted. It was opined that banks and MFs might be initial bulk investors in securities debt as they are well informed of the intricacies of financial innovations. It was suggested that working capital agreement between the financial institution and the borrower may exclude all receivables (which the financial institutions may acquire in due course of time) to be charged to the bank. The treatment of exposure to Originator or Obligator

should be made clearer. Treatment of up front income (difference between the yield earned on loans securitised and coupon rate for securitised debt over the tenure of the loan) should also be clarified. It was suggested that (i) RBI should issue clarifications to banks for issuance of NOCs within the definite time frame (as was done for Factoring), (ii) RBI should clarify that on securitisation deals, exposure will be on Obligors and (iii) Concessional finance should continue to be made available in the event of export receivable securitisation.

ILFS

5. The presentation by the ILFS on the subject of 'Infrastructure Financing and Securitisation' emphasised two major benefits of securitisation (i) cost of funding will be reduced (ii) larger number of investors can be approached for meeting the infrastructure needs. The presentation gave a background on infrastructure financing, securitisation in infrastructure financing and constraints in securitisation. The nature of funds utilised for infrastructure (ports, roads, power projects, water and sewage etc.) development was highlighted with the need to perceive risk involved at pre-commissioning and post- commissioning stages. It was pointed out that only a few institutions understand infrastructure risks.

Citi Bank

6. The bank is involved in securitisation since 1990. Shri Jayakumar emphasised the need of reducing the transaction cost and the creation of quality assets to develop securitisation in a significant way. He suggested that (i) in the short run, some guidelines can be framed to facilitate securitisation, (ii) in the long run, nodal agencies like NHB may undertake the activity of market maker by shifting from the role of refinancing in a phased manner. He opined that UK model is appropriate for Indian conditions. The trading in securitisation needs to be operationalised as some of the securitised debt in the past, although listed on the National Stock Exchange, was not traded. He also emphasised that structure / role of different agencies should be considered on a different footing from the issue of tax exemption. Reserve Bank of India (Department of Banking Operations and Development) may make uniform guidelines for investment in direct mortgage backed securities and asset backed securities. Shri Jayakumar also stated that the latest consultative paper of Bank for International Settlement, which gives lower risk weights for highest rated debt, might encourage high graded instruments in the area of securitisation.

Duff & Phelps Credit Rating India Pvt. Ltd. (DCR India)

7. Shri N.C. Roy, M.D., DCR India highlighted the relevance of the rating process in securitisation deals. He averred that the 'informed' investors will alone be deploying their funds on securitised papers and hence pointed out the need for transparency and information sharing of a high degree. This was followed by a detailed presentation by Shri A. Bhoumik of DCR India. He referred to the need of a guarantee company, as was the case with mortgaged loans in U.S.A. He stated that the support of guarantee companies could be considered towards extending credit enhancements especially for the infrastructure sector. Different future flow risks like product risk, obligor risk, etc. were highlighted. Referring to their past experiences, he stated that there had been no instance of default in the case of 117 international issuance on securitisation transactions rated by DCR between 1991-98 despite melt-downs in some of the emerging economies. The Group was informed that securitisation had survived economic downturn in Mexico during the Tequila Crisis of Mexico during 1995. Securitisation had also survived

corporate default in Venezuela, Pakistan and Indonesia. In the case of India, there is good scope for securitisation of future flows of oil and gas receivables, credit card vouchers receivables and tolls / rentals / service contracts / fees, etc. As a part of the rating methodology, he averred that DCR assesses the legal and payment structure, track record of the management, MIS irrespective of the originator or investors. He explained that due diligence process followed by them is exhaustive which includes assessment of origination / underwriting policies, random sampling, documentation, etc. Credit enhancement is determined by worst case scenario, review of concentration issues, etc. The rating rationale gives transaction details such as the originators, tenors, security, legal issues, pool characteristics, sensitivity analysis, cash flow statements (which influences the AAA or other ratings), etc. The periodic service reports include pool behaviour, delinquencies, etc. Drawing upon the experience of a live deal, he brought out the importance of backup services especially in the case of bankruptcy of the originator. The issues like filing of suits by receiving and paying agents and pass through nature of SPV were the other issues highlighted during the presentation.

Credit Rating Information Services of India Ltd. (CRISIL)

8. Shri D. Thyagarajan informed the Group that CRISIL had pioneered securitisation rating in India in 1991 and has rated about 50 securitisation transactions with volume aggregating to well over Rs. 4,500 crore. Various forms of credit enhancements used include cash collateral, over-collaterisation, spread account and guarantee. He pointed out that there has been no instance of downgrading of rating in securitisation transactions. There has also been fairly accurate prediction of pool performances. CRISIL engages legal experts during the process of finalisation of transactions. The feasibility of issuing asset backed securities in demat form to save on stamp duty and minimise documentation was also highlighted. The issues regarding interest tax (the treatment of interest gain to the Originator as one time revenue gain or a continuous flow of gains over the tenor of the asset) and tax deducted at source were also highlighted. He pointed out that there was no separate legislation on hire purchase or leasing transactions. He suggested that the rights of the lessors in documentation need to be clarified in Motor Vehicle Act. A view was expressed that it may be helpful if the ownership / endorsements in the books (Registration Books in the case of securitisation of motor vehicles) are in the name of SPV in the records of Transport Authorities. The need to create awareness about the securitised instrument among the investors especially pension funds, banks, etc.) was emphasised. The regulators may prescribe investments by various institutions based on the rating of the securitised instruments. There is a greater need for rating in case of securitised paper vis-à-vis a conventional debt paper in view of the complexity of the structure involved and the fact that only a pool of assets back the paper, without backing of any entity. Private placement may also need to be rated. He suggested that the offer documents may disclose (i) all risks, and (ii) the ratings assigned besides the rating rationale. Originator's annual report may disclose the securitisation kept off the Balance Sheets, extent and form of credit enhancement provided by the Originators and the potential liability therefrom. There is a need for accounting guidelines to be issued for originators, investors and SPVs. Some of the rating issues, which prevent the delinking of Originators' risks, are

- Commingling of cash flows,
- Lack of third-party services,
- Borrowers not used to making payments to parties other than the original lender, and
- Efficacy of third party services not tested out.

Due to these problems, CRISIL is not in a position to sign rating based only on quality of assets. There is also lack of legal case history to know how courts would view securitisation transaction in the event of the bankruptcy of the Originator.

Consultant, Asian Development Bank (Shri S.P. Ghosh)

9. Shri S.P. Ghosh gave a presentation on 'Opportunities for the development and growth of Asset Securitisation'. Shri Ghosh was a member of the team of 13 experts, which visited U.S.A. during 1995 to learn lessons from their securitisation experience. He highlighted the benefits of securitisation in a capital scarce economy like India. Securitisation helps in allocation of risk to the best owner. Non-credit risks are also measured and covered. It ensures direct reward for better credit quality and facilitates standardisation of industrial practices. Securitisation in India has to focus on greater communication between the Originator on the one hand and the auditors, rating agencies, investors, due diligence agencies, etc on the other. There is a need for the regulators to promote securitisation. He made a reference to the introduction of tax incentives in U.S.A. during 1981 by way of (i) loss allocation over residual life of assets; (ii) loss set off against past filing. From 1977 to 1999, assets worth trillions of dollars have been sold without default, loans have become cheaper and the regulators including U.S. Treasury are showing quick response to market responses in U.S.A. Shri Ghosh dwelled upon the focus areas for RBI. These included building of wide consensus on benefits of securitisation and encouragement of market development. Drawing from his experience in German market, where he had spent 6 months, Shri Ghosh referred to the nascent stage of securitisation during 1989-90, which culminated into the current matured stage of securitisation in a gradual way. He referred to the need of building skills in the area through different training institutions of RBI, seminars etc. Another suggestion was to reduce the risk weights in the securitised instrument to a level of around 20 per cent. He emphasised the need of high disclosure standards, which should be made mandatory. Specific sectors like housing and infrastructure should be focussed especially in view of the increasing role of HUDCO in urban infrastructure. For this purpose enabling institutions may be set up. Shri Ghosh referred to the need of specific notification to the institutional investors - banks, FIs and NBFCs. Individuals / retail investors may be targeted at a later stage. On the issue of SPV, he averred that SPV should only be a conduit having credible board and trustee character. Alternate structure in the form of MF, Trust, or Company should be allowed but all SPVs should be registered with RBI. There should be a separate chapter on SPV in RBI Act stipulating minimum capital, prudential norms, etc. SPV may not be treated as NBFC as monies held in Trust by SPV for investors are not deemed to be public deposits. As a conduit, SPV should be considered neither a borrower (S 58A) nor a lender (S 372 A). Speaking on the regulatory changes, he suggested amendments to Section 27 A & B of Insurance Act, 1938 to include securitised papers through a Notification by GOI. The guidelines should specify the capability of the organisation to handle the complex transaction before venturing into securitisation. This should include financial control, monthly reporting, audit co-ordination, pool extraction, portfolio MIS, systems upgradation and treasury skills (structuring, pricing, placement, etc.) The presentation ended with recommendations for amendments to RBI Act to allow for SPVs, clarification on money held by SPVs, inclusion of asset-backed securities in priority sector lending depending upon underlying receivables etc. The disclosure document should include the information on assets' historical performance, cash flow elements and appropriation, investment consideration and risk factors, legal and tax structure, seller's business etc. There should be sufficient due diligence by auditors. As investors, the exposure should be

treated against the asset class and not against the issuer or the instrument. Certain nodal institutions (infrastructure, housing, etc.) should be reoriented. Shri Ghosh emphasised the need to rewrite the laws. He referred to the compendium on transfer of property prepared by him during early 1998, which encompasses nine laws (four central and five state laws). One of the members expressed the concern that the current securitisation transactions may not be complying with all the legal requirements. Finally, Shri Ghosh emphasised the need for reporting the securitised transaction in RBI Bulletin / Website.

ANZ Investment Bank

10. Shri Kanti Shah and Ms. Geetika Hatangadi gave a presentation on 'Securitisation in the Australian Market'. Government sponsored mortgage programme was initiated in Australia during mid 1980s. Reserve Bank of Australia released prudential guidelines for securitisation during 1995. Banks and their subsidiaries have the largest pool of assets, which can be securitised. Australia has well defined foreclosure laws. Any mortgage loan with more than 80 per cent of loan to value (LTV) is backed by insurance. The securitised instrument ranges from tenure of 30 days (commercial paper) to MBS bond with a legal life of 30 years. There is a clear separation between the originator and SPV; an originator cannot own or control the SPV. The credit enhancement facility is limited in amount and time frame. Regarding the SPV structure, there is a complete tax exemption in case of trusts. In the case of corporate, the tax exemption is given in case the inflow and outflows are matching. During 1998, the share of offshore issues increased significantly compared with the domestic issues.

Annexure – II

(see para 4.5, 8.1.3 & 9.8 & 10.2.4))

Accounting Treatment

Approaches to accounting treatment for securitisation

1. There are broadly two approaches to accounting treatment for securitisation, namely,

   (i) `Indivisible unit approach', according to which the Originator accounts for the securitised assets which are considered to be transferred as indivisible units that are either entirely sold or entirely retained.

   (ii) `Financial components approach' which recognizes that securitised assets can be divided into a variety of components. For example, a loan portfolio, which is securitised may give rise to a servicing asset and an interest-only strip receivable etc., apart from the loan asset which is transferred. Thus, as per this approach, a component of the securitised asset may be sold, while the other components are retained by the Originator and, therefore, treated as separate assets.

2. It appears that the Financial Reporting Standard (FRS) 5 on `Reporting the Substance of Transactions' (issued in April 1994 in U.K.) broadly follows the first approach, i.e., the financial assets are considered to be transferred as indivisible units. On the other hand, the Statement on Financial Accounting Standard (SFAS) 125, on `Financial Instruments: Transfers', issued by the Financial Accounting Standards Board (FASB) in USA follows the financial components approach. The International Accounting Standard (IAS) 39 on `Financial Instruments: Recognition and Measurement' is broadly in accordance with the SFAS 125, i.e., it also follows the financial components approach.

3. The financial components approach requires that all assets obtained and liabilities incurred in consideration of the securitised assets should be recorded at fair values (where it is not practicable to estimate the fair value, the same is required to be taken at zero).

4. In India, at present, the generally accepted accounting principles, including the Accounting Standards issued by the Institute of Chartered Accountants of India, are primarily based on historical cost convention. In other words, the fair values are generally not recognized as the basis for valuation of assets and liabilities. One of the factors which hinders adoption of fair value as the basis of valuation is the non-availability of fair values of various assets because of lack of relevant markets.

5. In India, the securitisation of assets is still in infancy. Thus, the innovations of various financial components of securitised assets in the financial markets may not be impending. Accordingly, the financial components approach may not be relevant at present.

6. At present, in India, the basic issue with regard to accounting for securitisation is: Whether the securitised assets should be considered as an off-balance sheet item or not, rather than the esoteric issue of fair value basis for valuation of assets.

7. In view of the above, it appears that the approach adopted by FRS 5 in UK, i.e., indivisible asset approach, would be more relevant in the Indian situation. In any case, since the Research Committee of the Institute of Chartered Accountants of India (ICAI) is bringing out a Guidance Note on the subject, the approach to be followed in this regard would have to be decided by the Committee and thereafter approved by the Council of the Institute.

Accounting Treatment for Securitisation

8. Under both the above approaches to accounting for securitisation, the central issue is when can the securitised assets be removed from the balance sheet of the Originator. This issue is to be decided by answering the following two questions:

   (i) Whether the Originator has access to the **benefits** of the securitised assets and exposure to the risks inherent in those benefits; in other words, whether all significant risks and benefits in the securitised assets have been transferred by the Originator, and

   (ii) Whether the Originator has a **liability** to repay the proceeds of the notes issue.

   As per SFAS 125, the basis for removal from the balance sheet of the Originator is whether he has surrendered control over the securitised assets.

9. An issue arises as to which criteria should be adopted to decide whether significant risks and benefits have been transferred (or control has been surrendered) on the securitised assets. The conditions laid down in SFAS 125 are more detailed and appear to be more stringent. IAS 39 while providing for surrender of control, only gives illustrations of situations under which control can be considered to be lost. FRS 5 provides indicative criteria (Annexure `A') for deciding whether all significant risks and benefits in the securitised assets have been transferred. In resolving the issue of the criteria to be adopted, it is felt that in India, FRS 5 may be appropriate due to following reasons:

   (i) The criteria of transfer of risks and benefits would be more readily understood as the present generally accepted accounting principles are based on `transfer of risks and rewards of ownership' (e.g., in AS 9 on `Revenue Recognition') while resolving the issue of `substance over form'.

   (ii) SFAS criteria for surrender of control are too detailed, complicated and, therefore, may be too cumbersome to apply.

   The Research Committee of the ICAI may, however, consider prescribing specific criteria for deciding when significant risks and benefits in the securitised are transferred.

10. As per FRS 5 where the originator has transferred all **significant benefits and risks relating to the securitised assets and has no obligation to repay the proceeds** of the note issue, derecognition, i.e., removal of the securitised assets from the balance sheet of the originator is appropriate. On the other hand, where the originator has retained significant benefits and risks relating to the securitised assets from the balance sheet, it is

not appropriate to derecognise the securitised assets from the balance sheet, but an asset equal in amount to the amount of securitised assets is shown on the balance sheet of the Originator, i.e., it is not treated as an off-balance sheet item.

11. In practice, the Originator retains some benefits such as interest-only strip receivable or offer to perform some service related to the securitised asset, e.g., servicing of loans in return of some fee, providing liquidity to issuer in return of a fee etc., or there is a limited recourse obligation. As per SFAS 125, while it is possible that the originator surrenders control over the basic securitised asset, say, a loan, and, therefore, it qualifies to be recognized as a **sale (derecognition),** he may retain certain rights such as interest-only strip receivable and a service asset, which are recognized as assets valued on the basis of fair values. FRS 5 in the Application Note on Securitised Assets does not appear to prescribe such recognition of assets. In other words, as per FRS 5, it appears that the retention of rights and obligations of the aforesaid nature have to be considered in deciding whether significant risks and benefits in the securitised asset have been transferred and, then, on that basis, the `entire asset' is derecognized or continued to be recognized (`indivisible asset' approach). However, FRS 5 recognizes that there could be situations whereby even though significant risks and benefits relevant to the securitised assets have been retained by the originator but there is absolutely no doubt that its downside exposure to loss is limited. In such a situation, the Standard requires that a linked presentation should be used, i.e., the proceeds of the note issue to the extent they are not returnable should be shown deducted on the face of the balance sheet within a single asset caption. The Standard also requires various disclosures to be given in case of linked presentation.

12. The following are some examples of the accounting treatments of asset securitisation in different situations:

(i) An entity transfers, in a securitisation arrangement, a portfolio of debts of Rs. 100 in consideration of Rs. 100 and there is no recourse to the Originator in any situation. Since all significant risks and benefits have been transferred, the asset will be `derecognised' in the books of the Originator.

The following journal entry may be passed:

	Rs.
Cash/Bank A/C Dr.	100
To Debtors	100

(Being debtors of Rs. 100 transferred for a consideration of Rs. 100 under securitisation arrangement with M/s. _________)

(ii) An entity transfers, in a securitisation arrangement, a portfolio of Rs. 100 in consideration of Rs. 100 and a third party, say a bank, provides guarantee, to the Issuer. In the event the securitised assets are not realised by the Issuer, the bank pays the same to the Issuer. In case the bank does not have recourse to the Originator, in return of a fee, it may be said that all significant risks and benefits

in the securitised assets have been transferred. In such a situation also, the asset will be derecognised.

The journal entry will be the same as in (i) above in the books of originator.
In the books of the third party (credit enhancer), the following entry may be passed :

Profit & Loss Account Dr.
To Cash / Bank A/c.

(being entry to record the invoking of collateral on transaction with M/s._________)

(iii) An entity transfers title to a portfolio of debts of Rs. 100 (for which expected bad debts are Rs. 4) in return for proceeds of Rs. 95 plus rights to a future sum whose amount depends on whether and when debtors pay. In addition, there is recourse to the entity for the first Rs. 10 of any losses. Assuming the conditions for linked presentation as laid down in FRS 5 are met, the arrangement would be presented as follows:

		Rs.
Debts subject to securitisation:		100
Gross debts (after providing for bad debts)	96	
Less: non-returnable proceeds	(85)	
	11	

The remaining 10 of the finance would be included within liabilities.

The following will be the journal entries in respect of the above:

Provision for Bad Debts	Dr.	4
To Debtors		4

(Being the amount of expected bad debts provided for against the debtors of Rs. 100)

Cash/Bank A/C	Dr.	95
To Debtors		85
To Liability towards recourse under the securitisation arrangement of the debts.		10

(Being Rs. 95 received under the securitisation arrangement for debts and liability of Rs. 10 created in respect of recourse)

Securitisation of over-collateralised asset: Accounting at the time of selling the asset as well as at the time it flows back or in the event it does not flow back

13. In this situation, the assets transferred are in excess of the amount of consideration received by the Originator. The objective of transferring this excess is to provide security to the Issuer as the excess can be used by the Issuer in the event the securitised assets are not fully realised by the Issuer to the extent of the consideration paid to the Originator.

14. In the above situation, all risks and rewards are not transferred to the Issuer. If the amount received as a consideration is non-refundable, i.e., it is absolutely certain that this amount will not be returned to the Issuer, it may be appropriate to disclose the transaction as a linked presentation as suggested in FRS 5. *Thus, non-refundable amount received may be shown as a deduction from the gross amount of the receivables and the net amount of receivables will be shown in the outer column. A disclosure should, however, be made in respect of the net amount of the receivables that a charge exists in favour of the Issuer.* In case the Issuer uses these receivables, then these should be removed from the balance sheet and the loss to that extent be recognized in the profit and loss account of the period concerned. Where the Issuer reaches a situation under which he does not have to exercise recourse to the excess, the receivable would continue to be disclosed as a normal receivable. *In the books of the Issuer, the securitised receivables received should be shown to the extent of consideration received, i.e., the receivables received as a over-collateral should not be disclosed on the face of the balance sheet, but may be shown as a note to the accounts explaining the nature thereof.*

Revolving Period Securitisation

15. On a perusal of FRS 5 and SFAS 125, it appears from the accounting point of view, that the securitisation can be in respect of existing assets. For instance, para 52 of SFAS 125, related to `Revolving Period Securitisations (i.e., securitisation of certain types of receivables, say, credit card receivables, existing as well as to be received over a future specified period) states as below:

> "Gains or loss recognition for revolving period receivables sold to a securitisation trust is limited to receivables that exist and have been sold. Recognition of servicing assets or liabilities for revolving period receivables is similarly limited to the servicing for the receivables that exist and have been transferred. As new receivables are sold, rights to service them become assets or liabilities and are recognized."

In view of the above, *it appears that any money received for future cash flows by the Originator should be treated as a borrowing until its treatment as a securitised asset could be decided upon. The aforesaid treatment is justified in view of the fact that an asset or a liability should not be recognized which may arise in future. In accounting, only the past transactions or events can give rise to assets, liabilities, income and expenses.*

The following illustration would explain the amounting treatment:

An entity securitises 5 year future export sales for a consideration of Rs.100. Each year sales is Rs.20 for next 5 years. The following entries may be passed in securitisation :

Cash / Bank A/c. Dr. Rs. 100
To Export Sales Securitisation A/c. Rs. 100
(being 5 year export sale securitised with M/s. ________________________)

The Export Sales Securitisation Account would be shown on the liabilities side of the Balance Sheet. In year in which Export Sale take place the following entry may be passed.

Export Sales Securitisation A/c. Dr. Rs. 20
To Export Sales A/c. Rs. 20
(being Export Sales of the year accounted)

The Export Sales securitisation A/c. would be reduced to Rs.80 and shown on liabilities side of Balance Sheet. The Export Sales A/c. would be credited to Profit & Loss Account of the year.

Disclosures

16. The disclosure requirements would depend upon the method of accounting finally decided by the Research Committee of ICAI. However, in general, the following disclosures may be made:

    (a) the accounting policies followed,

    (b) the characteristics of securitisations, i.e.,

        (i) a description of the transferor's continuing involvement with the transferred assets including, but not limited to, servicing recourse and restrictions on retained interests,

        (ii) cash proceeds, and

        (iii) gain or loss from securitisation.

17. As discussed earlier, in India, perhaps the FRS approach may be more appropriate. A summary of three types of accounting treatments, namely, derecognition, linked presentation and separate presentation as per FRS 5 are given in Appendix 'A'.

18. Issuer (SPV) may maintain balance sheet of its own. Considerations similar to those related to accounting for securitisation in the books of the originator also apply in relation to accounting in the books of the Issuer. In the books of issuer, mirror entry to the entry passed by the originator should be passed. For e.g. on the facts given in para 12(i), the following entry would be passed :

    Debtors A/c. Dr.
    To Cash / Bank A/c.

Issuer (SPV) may maintain balance-sheet of its own.

Valuation of Investments in Loan Notes by Noteholders

19. Another issue, which may be of relevance, is how the noteholders would value their investments in the loan notes, keeping in view the fact that there may be certain peculiar features in respect thereof. For example, the notes may be redeemed by the issuer in installments based on the receipts from the securitised loans, the amounts and the timings of which may or may not be reasonably certain. It is, therefore, argued that such notes may be valued on the basis of the net present value of the expected net cash inflows over the period of the investments. In this context, it may be noted that at present also some securities exist which provide for periodical piecemeal redemption. It is submitted that such securities are presently valued as per the requirements of Accounting Standard (AS) 13, `Accounting for Investments', issued by the Institute of Chartered Accountants of India. The said standard does not exempt securities of the nature of loan notes issued under a scheme of securitisation. *Thus, it appears that the loan notes should also be valued at cost, if investment therein is considered of long term nature and at the lower of cost and fair value if they are in the nature of current investments, as per the requirements of AS 13. However, provision for diminution should be made to recognize a decline other than temporary in the value of the long term investments.*

20. The broad issues raised in the above paragraphs are still to be resolved by the Research Committee and the Council of the ICAI. In view of this, the views expressed herein regarding preference for accounting treatments as per FRS 5 may undergo change.

APPENDIX ‘ A ’

Originator's financial statements

Indications that derecognition is appropriate (securitised assets are not assets of the originator)	Indications that a linked Presentation is Appropriate	Indications that a separate Presentation is Appropriate (Securitised Assets are assets of the originator)
Transaction price is arm's length price for an outright sale.	Transaction price is not arm's length price for an outright sale.	Transaction price is not arm's length price for an outright sale.
Transfer is for a single, non-returnable fixed sum.	Some non-returnable proceeds received, but originator has rights to further sums from the issuer, the amount of which depends on the performance of the securitised assets.	Proceeds received are returnable, or there is a provision whereby the originator may keep the securitised assets on repayment of the loan notes or re-acquire them.
There is no recourse to the originator for losses.	There is either no recourse for losses, or such recourse has a fixed monetary ceiling.	There is or may be full recourse to the originator for losses, e.g.: - originator's directors are unable or unwilling to state that it is not obliged to fund any losses; - noteholders have not agreed in writing that they will seek repayment only from funds generated by the securitised assets.

Annexure – III

(see para 8.1.5, 10.2.5 &, 10.3.2)

Asset Securitisation - Disclosure of Information to Investors

Introduction :

Securitisation is a new and emerging concept in India. However, it has the potential to become one of the largest sources of debt finance in the country. One of the key elements in the development of this market would be investor acceptability. While in the initial stages, the market is expected to be limited to institutional investors, eventually it has to attract the participation of retail investors. Considering the novelty of the concept, it is imperative that investors are able to identify and comprehend the various risks associated with investing in securitised debt and make an informed investment decision. Investor acceptability would be driven by the extent to which such risks are disclosed and explained. In this context, the need for adequate disclosures and information dissemination mechanism cannot be overemphasised.

The present paper seeks to outline some of the key information requirements that are required to be disclosed in the Offer Document as a best practice model. While recognising that the nature of information would vary depending on the types of asset classes that would be securitised, an attempt has been made to introduce an element of uniformity in the disclosure requirements across asset classes.

Information requirements

(i) <u>Terms of the Offer</u>

The offer document should seek to provide information describing the terms of the offer. Typically the summary terms of the offer should include :

a) Description of the instruments (pass through, pay through, Class A, Class B etc.)
b) Maturity/Redemption
c) Interest rate, probable yields
d) Interest and principal payment dates
e) Optional redemptions, if any
f) Description of underlying Security
g) Terms of payment
h) Minimum Application
i) Interest rate on application money
j) Offer programme - Opening and Closing dates
k) Listing details / Transferability
l) Rating of the securities and explanation of the rating. The text of the rating rationale could be provided as an Annexure.

   The rating rationale should seek to comment on the following :

   - Quality of the receivables and strength of the cash flows
   - Payment structure
   - Adequacy of the credit enhancements

- Originator profile
- Risks and concerns for investors and the mitigating factors
- Any other relevant information

(ii) Description of the Issuer (SPV)

This should include constitution, activities, ownership, capital structure and other details of the Issuer

(iii) Objects of the Offer and end use of funds

(iv) Transaction Structure

The structural summary should provide brief information regarding the key structural features of the transaction. This would include :

a) Transfer of receivables and flow of funds (ideally represented by a schematic diagram)
b) Priority of distributions and allocation of funds
   - Servicing Fee, Trustee Fee etc.
   - Class A Securities Interest
   - First allocation of principal
   - Class B interest
   - 2nd allocation of principal
   - Reinstatement of reserve account, if any
c) Early Amortisation events, trigger clauses etc.
d) Events of default and change in priority of distributions on occurrence of such events

(v) Statement of Risk Factors

The investors should be informed about the risk factors typical of investing in instruments of securitisation. (This would be in addition to normal disclosures on market risks associated with investments in securities). Normally, these would be :

a) Prepayment risks – Prepayment on receivables will cause prepayments on the securities resulting in reinvestment risk to the investor
b) Potential loss on securities due to limited assets of the SPV
c) Bankruptcy of originator could result in losses or delays in payments on the securities (i.e. in the event the court in the bankruptcy proceedings concludes that the sale is not a "true sale")
d) Prepayments, potential losses and change in order of priority of principal payments following an event of default.
e) Risks arising out of geographic concentration of receivables, if any
f) Any other risk specific to the transaction and asset class.

(vi) Disclaimers

That ,

- The ABS / MBS do not represent deposits, liabilities of the originator, servicer, SPV or the Trustee and that they are not insured
- The Trustee / originator / servicer / SPV does not guarantee the capital value of the ABS or the collectibility of the receivables pool
- The Regulators are not liable for any losses to the investors

(vii) Information related to other risks

The extent of information requirement would depend on the nature of risk associated with a particular transaction. Broadly stated, these risks are asset risk, third party risk, legal risk, and

cash flow risk. Of course, in addition to these risks, investors bear the market risk that the value of their investment will change. The disclosures in the offer document should not only aim to inform the investors about these risks but also provide sufficient information on the various parameters governing these risks so that they are able to assess and measure these risks.
Given this objective, the broad disclosure requirements against each of the risk categories could be as under:

A. Asset risk

The assets backing a securitisation are its fundamental credit strength. Therefore, the risk associated with the performance of the asset(s) and the obligors behind them needs to be analysed and disclosed in detail.

The standard disclosures on asset performance could be:

I. Description of the assets: For example, if the asset is a pool of loans (e.g. car loans), **pool information** would comprise the following :

a) Summary of the pool of loans:

Number of loans in the pool :
Original loan amount disbursed :
Loan outstanding as on ------
Maximum loan amount :
Minimum loan amount :
Average loan amount :
Original maturity of the loans :
Residual maturity of the loans :
Minimum original Loan to value ratio:
Maximum original Loan to value ratio:
Weighted average original loan to value ratio :
Weighted Interest rate of the pool :

b) Distribution of pool by original Loan to Value ratio *

*** Explanation of LTV ratio and its implications to be provided for the benefit of understanding by retail investors**

LTV	No.of loans	Proportion of total pool by number	Outstanding Principal Amount	Proportion of total pool y amount	Weighted Average Original LTV
<=60 %					
60-70%					
-----					

c) Distribution of pool by outstanding principal amount

Princ. O/S	No.of loans	Proportion of total pool by number	Outstanding Principal Amount	Proportion of total pool by amount	Weighted Average Original LTV
< 5 cr.					
5-10 cr.					
-----					

d) Distribution of pool by residual maturity

Residual maturity (months)	No.of loans	Proportion of total pool by number	Outstanding Principal Amount	Proportion of total pool by amount	Weighted Average Original LTV
25					
26					
-----					

e) Geographical distribution of pool

Location	No.of loans	Proportion of total pool by number	Outstanding Principal Amount	Proportion of total pool by amount	Weighted Average Original LTV
Delhi					
Mumbai					
-----					

f) Distribution by interest rates

Interest (%)	No. of loans	Proportion of total pool by number	Outstanding Principal Amount	Proportion of total pool by amount	Weighted Average Original LTV
< 15					
15-16					
-----					

g) Distribution by loan types

For certain specific type of loans like student loans etc. some additional disclosures on the following lines may be required :

Loan Type (%)	No. of loans	Proportion of total pool by number	Outstanding Principal Amount	Proportion of total pool By amount
Subsidised				
Unsubsidised				
Guaranteed				

II. Declaration on historical performance (delinquencies / defaults / overdues / guarantee claims if any, etc.)

The Originators experience with respect to its portfolio of loans / sales contracts. While it is not necessary that the behaviour of the pool will be comparable to the originator's experience, it may be necessary to provide some indications to an investor on the past performance. For example, for a pool of consumer loans (say) :

a) Delinquency experience

		1997	1998	1999
E.g.	Average number of contracts outstanding			
	Average monthly number of contracts delinquent			
	Average monthly delinquencies as a % of average contracts outstanding			

b) Credit Loss and Repossession Experience

	1997	1998	1999
Average portfolio outstanding			
Repossessions as a % of Average			
- Number of contracts outstanding			
Net losses as a % of average portfolio outstanding			

* "Net losses" are equal to the aggregate balance of all contracts which are determined to be uncollectible in the period less any recoveries on contracts charged off in the period or prior periods

III. If the asset is in the nature of a debt from a **single obligor** (e.g. lease rental from a corporate / loan from a single corporate), then detailed information about the obligor performance needs to be suitably disclosed. Such information could comprise the following :

a) Description of the obligor's activities
b) Past 3 years of financial performance
c) Existing ratings of outstanding securities
d) Declaration on outstanding disputes/ litigation
e) Past defaults etc.

If the asset is in the nature of a pool of debt from **multiple obligors**, such information could be provided for those obligors whose debt constitute more than 25 % of total debt in the pool.

IV. Information about Originator : To arrive at a judgement on the likely performance of an asset in future, investors would also need to have adequate information about the originator and the credit origination procedure. This is particularly relevant for future flow receivables where the performance risk remains linked to the originator. Information about the originator could comprise the following :

a) Business profile of the Originator
b) Industry structure and the competitive scenario
c) Capital Structure
d) Management
e) Credit extension norms and process. This would include a statement on the loan sanctioning criteria, appraisal norms, approval mechanisms, credit supervision & collection mechanism etc.
f) Asset quality and capital adequacy
g) Loan default / Credit loss – historical experience
h) Claims against the Originator, disputes, contingent liabilities etc.

B. <u>Third party risk</u>

In the absence of its own executive staff, an SPV must rely on third parties to provide all its services and execute all its functions. Other third parties provide credit enhancement and ancillary facilities to SPVs as appropriate to the specific asset backed transaction. At the interface between the SPV and the investors, additional third parties carry out trust and agency responsibilities. The investors are at risk on the solvency and performance of each third party which bears responsibility for passing funds through to the SPV or onwards to investors. Information requirements on third party risk could be as under :

I. <u>Credit Enhancer Risk :</u>

a) External forms of credit enhancement : For example, if the performance of an asset is guaranteed by a third party then adequate information about the credit strength of the guarantor needs to be provided. Such information could be in the following format :

(i) Brief description of the Company's activities
(ii) Past 3 years financial performance
(iii) Details of outstanding guarantees and other contingent liabilities
(iv) Existing ratings of the Company's outstanding debt securities

b) For internal forms of credit enhancements :

(i) Information about the extent of overcollateralisation
(ii) Information about the cash collateral reserve account (e.g. mode of the collateral – cash deposit, L/C, bank guarantee etc., replenishment / reestablishment mechanism)

II. <u>Administration / Servicing risk</u>

Given that the cash generated by the asset is the fundamental strength of a securitisation's credit quality, it follows that proper administration of the underlying receivables is a fundamental third party risk. The prime task is the timely collection of receivables. In this role the administrator conducts all correspondence and contacts with the obligors over their performance including enforcement of any related security. If physical security underlies the receivables portfolio, the

administrator is responsible for the safe custody of the supporting security. As a natural corollary of its collections responsibilities, the administrator is also charged with operating the SPV's bank accounts, with keeping accounting and management information records on behalf of the SPV and with reporting on the performance of the portfolio at regular intervals. Internationally, while specialist third party administrators do exist, the seller of the assets usually continues to administer them under contract to the SPV.
In view of the above, the following information about the administrator/servicer needs to be disclosed :

a) Duties of the servicer – This would imply disclosing salient features of the Receiving and Paying Agency (RPA) / Servicing and Paying Agency agreement. The agreement could form a part of material disclosure.
b) Servicing compensation
c) Procedure for replacement of Servicing and Paying Agent
d) Information furnishing obligations of the Administrator / Servicer to the Rating agencies / Trustees

III. Disclosure on Trustees

(i) Brief profile of the Trustees
(ii) Duties and responsibilities
(iii) Remuneration
(iv) Procedure for replacement

C. Legal Risk

The Offer document should seek to apprise the investor about the legal aspects of the transaction. The investors should be aware of their interest and rights on the receivables and the underlying collateral. Information about repossessions / foreclosures etc. should be furnished. If any legal opinion is obtained (e.g. opinion on true sale etc.), the same should be appropriately reproduced with the consent of the opinion provider.

Suitable disclosures regarding the Deed of Assignment, agreement to assign etc, should be made. The Deed of Assignment should be made part of the Material Document.

Taxability

Disclosures on the taxability of the SPV, and the holders of the securities, supported by appropriate legal opinion / clarifications should be made.

D. Cashflow Risk

The manner in which the cash generated by the assets and third party facilities backing a securitisation is channeled to debt holders is the focus of cash flow risk. Cash intended to service or repay debt holders may come from a number of sources – principally collections on underlying receivables, draws on credit enhancement facilities etc. There is an associated credit risk on the administrator who, as originator, may be in direct receipt of collected funds or draws under credit enhancement facilities. To apprise the investor of these risks, the offer document should seek to disclose details of:

a) Operation of different collection accounts

b) Cashflow appropriation and distribution. Details of any structured payment mechanism (escrows etc.) should be provided.
c) Detailed cash flow schedule for the life of the instrument(s), assumptions underlying the cash flow projections
d) Treatment of prepayments and historical prepayment pattern
   Prepayment risk exists in most pass through structures and affects the average life of the securities. Prepayments expose the investors to reinvestment risk and therefore, some indications of historical prepayment patterns may have to be disclosed.

Continuing Disclosures
In addition to the initial disclosures in the offer document the investors would need to be apprised of the performance of the asset on a continuous basis at periodic intervals throughout the life of the security. Such information should comprise the following:
(i) Collection summary for the previous collection period
(ii) Asset pool behaviour – delinquencies, losses, repurchases, prepayments etc during the period
(iii) Drawals from credit enhancements, if any
(iv) Distribution summary
  - in respect of principal and interest to each class of security holders
  - in respect of servicing and administration fee, trusteeship fee etc.
  - payments in arrears
(v) Any other information relevant to the performance of a particular asset class

Normally, information on the asset performance is periodically reported to the rating agency(s) who have a system of surveillance through which the performance of the asset portfolio is monitored on a continuous basis. It is suggested that such information is also made available to the Trustees and the Stock Exchanges where the instruments are listed, at quarterly intervals throughout the life of the instrument. Further, the rating agencies could be requested to publicise the rating of the instruments at quarterly/semiannual intervals.

Conclusion :
As mentioned earlier, the extent and nature of information disclosure requirements would vary depending on the typicality of the asset class that is being securitised. For example, the disclosure requirements for an existing asset which is in the nature of loans would be different from that of future flow securitisation transactions like securitisation of future ticket receivables, future remittance securitisation etc.
This issue may be addressed in two ways :
a) The regulator may specify, *ab initio*, the type of asset classes that could be securitised and specify the disclosure requirements separately for each asset class

b) The regulator may lay down general norms of disclosure which would be common to all asset classes (for example, information pertaining to third party risk, cash flow risks etc) and retain the right to scrutinise and approve specific disclosures that may be required for separate asset classes.

Instruments of securitisation may be offered to investors either by way of private placement or by public issues. Although disclosures in regard to private placement of debt is not regulated by any agency at the moment, it is recommended that there should be certain minimum disclosures even for private placements for best practice, that could be modelled on the lines described above. For public issues such disclosure requirements should be made mandatory by the regulator. It is also suggested that every securitisation issue be rated by minimum one credit rating for issues upto Rs. 100 crore and by two rating agencies for issues above Rs. 100 crore and that both the rating/s be made public along with the rating rationale.

Annexure - IV

(para 8.1.8, 10.2.2.2, & 10.2.6)

Proposed Prudential Guidelines for Asset Securitisation

Objectives of securitisation:

The banks, FIs or NBFCs may seek to achieve one or more of the following objectives by securitisation:

1. To create room in the balance sheet to meet the capital adequacy norms prescribed by the regulatory authority.
2. To increase return on equity by redeployment of the capital in higher yielding assets.
3. For the purpose of risk management.
4. To correct large exposures to borrowers, asset classes or geographical concentrations.
5. To reduce the cost of funds and achieve diversification of sources of funding.

Rationale for regulation:

In a securitisation transaction the functions carried out by the originator and the corresponding risks associated with such functions are unbundled and distributed across different participants. The capital maintained against the assets by the bank prior to the securitisation provides cushion against all the risks associated with the asset of which credit risk is the most prominent. In the post securitisation scenario the originating bank manages to pass the credit risk to third parties but may still be left with risks associated with loan servicing or moral recourse risk. Moral risk may assume significant proportions in the case of a single loan securitisation where close association of the originator with the loan can not be camouflaged whereas in a pool of loans the level of association may not be so prominent. On the other hand the array of roles a bank may have to carry out is large in securitisation of a pool of loans than in a single loan. From the regulators point of view a bank carrying out one role will have more regulatory freedom than one carrying out several roles for obvious reasons. Further, close identification of a bank with a loan makes it more amenable to moral risk. As a result it may be under pressure to support losses incurred by the investors/buyers to protect its reputation. Likewise, a sponsor may be more open to moral risk than a mere repackager in securitisation scheme of certain types where the originator is merely a conduit and assets never had been on its balance sheet.

Therefore, depending on the roles carried out by a bank in a securitisation scheme the regulatory guidelines will aim to determine the measure the bank should take to hedge risks associated with such roles. The regulatory prescriptions are normally in the form of capital charge. In certain cases, however, the regulatory authority may impose limits on the size and types of assets to be securitised.

The guidelines are *mutatis mutandis* applicable to the sponsors and repackagers of loans. If, however, the assets at any time appeared on the balance sheet of the repackager the same are not considered a repackaging scheme. Moreover the repackaging should be undertaken in freely tradable bond and securities.

Reporting:
The Regulatory Authorities in all the emerging markets as well as some of the developed countries retain control over the securitisation by the banks and the financial institutions under their jurisdiction. The control is in the form of either prior consultation as is the case in England under the FSA guidelines, Hong Kong under Hong Kong Monetary Authority (HKMA) guidelines or prior approval by the respective authorities in Singapore, Malaysia, Philippines, Korea and Thailand etc. The Regulatory Authorities want to assess the impact of the securitisation deals on the risk profiles of the banks and FIs. In a recent study by BCBS on Capital Requirements and Bank Behaviour, it has been brought out that the banks in US are using securitisation to alter the profile of their book. The situation elsewhere would be no different. This may make a bank's capital look artificially high relative to riskiness of the remaining exposures, and in some cases may be motivated by a desire to achieve exactly this. The very broad categories in the Basle Accord give scope for the banks to arbitrage between their economic assessment of risk and the regulatory capital requirement. Securitasition is an important technique for undertaking such capital arbitrage but may not be sole motivation. Capital arbitrage exploits the large divergence that can arise between a portfolio's true economic risk and the regulatory measure of risk. There are four major types of capital arbitrage:

- Cherry picking.
- Securitisation with partial recourse
- Remote origination
- Indirect credit enhancement.

The measurement of credit risk is a difficult task and can never be done in absolutely precise terms. Therefore, the regulatory authority needs to be reassured that the banks and FIs are sufficiently equipped to handle the risks to which they may be exposed and the scope for capital arbitrage can be minimized. Hence it is felt that banks and FIs (including NBFCs) intending to originate securitisation deals should inform their plans to the regulatory authority at least one month in advance.

The secritisation program should have the approval of the Board of Directors of the originating institution.

Focus of the guidelines:
The regulatory guidelines will broadly address the following concerns:

1) All parties involved in the securitisation understand responsibilities and risks they assume and provide for the same.
2) The intended reapportionment of rights and obligation as a result of securitisation is achieved among sellers, buyers and other service providers and the same is well documented and legally enforceable.
3) The risks arising from securitisation are hedged through appropriate measure like capital charge or other stipulations.
4) Complete legal, economic and moral separation of seller from assets and new owners.

5) The remaining assets portfolio of the institution should not deteriorate to such an extent that it becomes a mater of concern for the regulatory authority .

It may be added that securitisation is an area , which is continuing to develop, and the Indian Regulators will continue to review their policy in the light of market developments.
In order to achieve the above concerns the following guidelines are being proposed which are in consonance with international best practices:

Criteria for True Sale:
It is important that the originators are not required to contribute for any expenses / losses to investors beyond the documented credit enhancement and other expenses.
In order that the originators are able to remove the assets from the balance sheet and get the regulatory capital relief, the following conditions should be met:

i. Transaction price for transfer of assets from originator to SPV should be market based and at arm's length basis.
ii. The transferred assets should have been isolated from the transferor i.e. put beyond the reach of transferor and its creditors even in bankruptcy. Transferee /SPV and holders of beneficial interests in the assets of SPV obtain the right to pledge or exchange the transferred assets free of any restraining condition.
iii. The transferor does not maintain effective control over the transferred assets through an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity.
iv. All risks and rewards of the seller in respect of the assets should have been fully transferred to SPV. A seller may however, provide credit enhancement to the securitisation structure on the terms set out in the guidelines. A seller may also be entitled to any surplus income generated over the life of securitisation transactions by means of a separate written agreement with SPV.
v. An opinion from the solicitors/external auditors of the seller should be kept on record signifying that all rights in the assets have been transferred to SPV and originator is not liable to investors in any way with regard to these assets. Regulatory authority expects the servicing agent and originator to have evidence available in their records that their auditors and legal advisors are satisfied that the terms of the scheme protect them from any liability to the investors in the scheme, other than liability for breach of express contractual performance obligations.
vi. The buyer should have no formal recourse to the seller for any loss except through the mechanism of credit enhancement or liquidity facility for which a written agreement should be entered into at the time of origination of securitisation.
vii. The seller may not give any representation or warranty in respect of the capital and/or future performance of the ABS issued by SPV as well as future credit worthiness of the underlying assets.
viii. The transfer of assets from seller must not contravene the terms and conditions of any underlying agreement governing the assets and all necessary consents should have been obtained to make transfer fully effective.
ix. The seller should not be under any obligation to repurchase any asset sold except where the obligation arises from a breach of any representation or warranty given in respect of

the nature of the assets at the time of transfer. A notice to this effect should be given to the SPV and investors and they should have acknowledged the absence of such obligation. An option to repurchase fully performing assets at the end of the securitisation scheme where such assets have in aggregate fallen to less than 10% of the original amount sold to the SPV (clean up calls) may, however, be retained by the seller.

x. Seller should not be involved as a market maker in the securities backed by asset sold by him by giving two way quotes.

xi. Seller may purchase senior securities issued by the SPV at market price for investment. Such purchase should not exceed 5% of the original amount of the issue.

xii. Except for underwriting commitment seller must not commit it to purchase securities prior to initial issue.

xiii. The seller may underwrite the issue of securities by the SPV on an arms length basis. The devolution of any subordinated notes on the seller, as a result of underwriting, will be deemed as a credit enhancement for the purpose of capital adequacy treatment. Any devolved senior or subordinated securities should be brought to the notice of the Regulatory Authority and disposed off in a time bound manner.

xiv. The seller and SPV may enter into currency/interest rate swap arrangements for hedging purposes. Such transactions must be entered into at market rates.

xv. In case of any re-schedulement or re-negotiation of any loan included in the assets the SPV and not the seller would be subject to altered terms if any.

xvi. If the payments are routed through the seller he should be under no obligation to remit funds to SPV unless and until these are received from the borrower.

xvii. The originator should not hold substantial interest in the SPV either directly or indirectly. They may however have one member on the board of directors. Further, the name of SPV should not have any resemblance with the name of the originator.

If the above conditions were not fulfilled then the transfer of assets would not be regarded as a true sale but only a financing transaction. The seller in that case should reflect the underlying assets on its balance sheet for capital adequacy purposes. RBI may regard assets removed from a bank / Financial Institution/ NBFC's balance sheet through securitisation, even where the scheme meets RBI's requirements, as carrying some residual risk to the Originator (e.g., pool of assets not properly segregated from Originator’s other assets, co-mingling of cash flows etc.).
(Terms seller and buyer have been used interchangeably for Originator and SPV)

Guidelines for Providers of Credit Enhancement Facilities :
Credit enhancement facilities include all arrangements viz. subordinated loan, over-collateralistion, spread accounts, investment in subordinated tranches of securities etc. that, in form or substance, provide for a seller or a third party agent to absorb the losses of a SPV or investors. These facilities play an important role to enhance the credit rating of the securitisation instruments. Credit enhancement arrangement should ensure that the following conditions are fulfilled:

i. The nature of the credit enhancement provided to a transaction is clearly specified in a written agreement at the time of origination transaction and disclosed in the offering document. There should not be any recourse to the enhancer beyond the fixed

contractual obligations so specified. In particular the enhancer should not bear any recurring expenses of the securitisation.

ii. The facility should be provided on an arms length basis and is subject to enhancer's normal credit approval and review process. The facility should be provided on market terms and conditions.

iii. The facility is limited to a specified amount and duration.

iv. In case where the enhancer is the seller, the credit enhancement facility must be documented in a way that clearly separates it from any other facility provided by the seller.

v. Where any of the above condition is not satisfied the enhancer is required to hold capital against the full value of all the securities issued by the SPV.

vi. The enhancer will be required for capital adequacy purpose, to deduct the full amount of credit enhancement facility from its capital base. The deduction will normally be capped at the amount of capital, which the seller would be required to hold for the full value of the assets if they had not been otherwise securitised. The authority may, however, impose a higher regulatory capital charge, if it considers necessary to do so in the prudential interest of the enhancer.

vii. In the case where seller transfers assets to a SPV for a value below their book value (e.g. under an over collateralisation agreement or by sale at a discounted price), the difference should be treated as a credit enhancement, unless the seller writes off the difference in value upfront against its P & L A/c.

viii. Credit enhancement should be undertaken only at the initiation of the scheme except in the event of a scheme having subsequent tranches of assets being placed in to the SPV.

ix. It should be examined whether banks would be allowed to provide guarantees to investors for the limited purpose and credit enhancement.

x. The credit enhancement in the form of guarantees will be treated as commitment and converted at 100% conversion factor.

Guidelines for Providers of Liquidity Facility :

(i) Liquidity facility enables an SPV to assure investors of timely payments. This includes smoothing timing differences in the receipt of interest and principal on pooled assets and servicing the securities. In view of the variety of cash flows to be provided to the investors, it may be unavoidable for the SPV to resort to temporary liquidity facilities from different suppliers of such credit. The provider of liquidity facilities to a SPV should ensure that the following conditions are met.

(a) The provider must not bear any of the recurring expenses of securitisation.

(b) The facility should not be capable of being drawn for the purpose of credit enhancement.

(c) The nature of credit facility provided to a SPV should be clearly specified in a written agreement at the time of origination of the securitisation transaction and disclosed in any offering document. There must be no recourse to the provider beyond the fixed contractual obligation.

(d) The facility should be provided on an arms length basis and be subject to providers' normal credit approval and review processes. The facility must be on market terms and conditions.

(e) The facility should be limited to a specified amount and duration.

(f) The facility should be reduced or terminated should a specified event relating to deterioration in the asset quality occur.
(g) Payment of fees or other income for the facility should not be subordinated, subject to deferral or waiver.
(h) Funding should be provided to SPV and not directly to the investors
(i) Funding under liquidity facility shouldn't be used to cover losses of the SPV.
(j) Drawings under the facility should be repaid within a reasonable period and should not be subordinated to the interest of the investors.

(ii) Liquidity facility will be treated as commitment to provide finance for capital adequacy purposes.
(iii) In case the liquidity facility fails to meet requirement (a to k) above, it will be treated as credit enhancement for the purpose of capital adequacy treatment.
(iv) The Originators may not provide liquidity facility to their securitisation schemes without the prior permission of Regulating Authority.

Guidelines for Service Providers:
A service provider will normally assume obligations such as collection from obligors, payment to the investors, reporting on the performance of the pool etc. in an asset securitisation scheme. These functions may continue to be performed by the professional organisations having the desired skills. A bank or a FI may act as a servicer for the SPV provided that:

i. There is formal written agreement in place that specifies the services to be provided and standards of performance required from the servicer. There should not be any recourse to the servicer beyond the fixed contractual obligations specified in the agreement;
ii. The services are provided on an arm's length basis, on market terms and conditions;
iii. The SPV and/or investors have the clear right to select an alternative party to provide the facility;
iv. The facility is documented separately from any other facility provided by the bank or FI;
v. Its operational systems (including internal control, information system and employee integrity) are adequate to meet its obligations as a servicer.

A bank or FI acting as a servicer should be under no obligation to remit funds to the SPV or investors until it has received funds generated from the underlying assets. Where the conditions as above are not met the service providers may be deemed as providing liquidity facility to the SPV or investors.

Additional guidelines for special structures:
Revolving structures:
1) The structuring of the securitisation of revolving credits should ensure full sharing of interest, principal, expenses, losses and recoveries on clear and consistent basis. There should be full loss sharing on the receivables in the pool throughout the revolving period of securitisation.
2) The scheme should not contain any feature whereby the performance of the pool systematically favours the investor's interest.

3) Adequate seasoning of the accounts transferred in the pool should be done as also the random selection of assets into the pool to ensure that investors do not derive any systematic advantage.
4) The servicing practices should be applied consistently to securitised and unsecuritised assets.
5) The scheduled amortization should not be so structured that the investors might avoid their full share of losses at the end of the revolving period.
6) The scheduled amortization should be so structured that the borrowers in the pool should have made sufficient payments to ensure that 90% of debt outstanding at the beginning of the amortization period or recognized in default.
7) The early amortization triggers should not be such that in effect these provide implicit credit support to the investors. There should be full sharing of interest, principal, expenses, losses and recoveries on the balances at the start of the amortization period.
   The bank also should be able to reduce its lending, without loss of reputation, in consonance with amortization of investors' interest if losses reach beyond tolerance level.
8) The liquidity implications of revolving structures should be handled within the banks' asset liability management system. Each scheme should be included in a banks' ALM system assuming that the bank may be required to find replacement or additional funding for the full amounts previously provided by the investors interest. In addition, a bank should include warning indicators for early amortization triggers and committed facilities capable of being drawn in case of need.

<u>Securitisation of financing of equipment and consumer goods:</u>

1) There are certain liabilities involved in such financing which are difficult to transfer to buyers of receivables in a securitisation transaction e.g. servicing of equipment by lessor or under hire purchase agreement or liability for personal injury etc. It is important, therefore, that the seller should either receive indemnity from the buyer or minimize the risk through appropriate insurance cover.
2) If the bank is buyer of such assets it should satisfy itself of seller's competence to fulfil its obligations towards borrower in a timely manner failing which borrowers may renege on their commitment to pay.

Investment in ABS/MBS:

i. The investment by the banks and FIs in securitised instruments irrespective of the form should be treated at par with the debt instruments and no limit should be placed on such investment.
ii. If the investment in securitised instruments exceeds 10% of the total investments of an institution the same should be disclosed to the regulatory authority.
iii. With a view to encourage investors to assume credit risk in those sectors of the economy where they would not invest normally, but those sectors are important for the overall economic development of the country, the government / central bank has been encouraging investments in these sectors by financial institutions. It is therefore felt that investment in securitised instruments backed by receivables from the following sectors should be given Priority Sector Lending status:
   - Infrastructure
   - Housing

- SSI, SRTO

iv. Overseas investors should be allowed to invest in the securitised instruments. A policy regarding this should be framed and made public.

v. The net result of securitisation is greater credit transparency, isolated risk ownership, and segmented risk absorption, which results in a funding cost that is lower than traditional lending. As a result, securitised instruments require lower level of capital support to provide similar levels of protection to holders of such instruments. The risk weight for investments in securitised instruments need to be defined. Bank for International Settlement has recently published a suggestive paper stipulating risk weights based on the credit ratings. These were deliberated in detail and it was felt necessary to suggest suitable risk weights to encourage investment in such instruments based on credit ratings as ratings will play an important role in attracting investors. The Group felt that there should be minimum risk weight for the best-rated paper, which has superior identifiable cash flows (AAA to AA-). With adequate disclosure norms and mandatory ratings, the quality of the underlying assets in the securitisation transaction is more transparent for an informed decision by an investor. For low quality papers (BBB+ to BBB-), the investors may have to maintain 100% capital adequacy. It may be added that the risk weights of the securitised papers are based on the proposals contained in the BIS paper on the subject, which is still under consultation process till March 2000. The actual risk weights may be decided by RBI after Basle Committee recommendations are implemented.

vi. For the purpose of capital adequacy on the investments in securitised paper the following risk weights should be applied:

Rating of the security(S&P methodology or Equivalent)	Risk Weight to be applied %
AAA to AA-	20
A+ to A-	50
BBB+ to BBB-	100
BB+ or below/unrated/Subordinate tranches	To be deducted from the capital subject to a cap of capital requirement on total assets securitised

The investment in residential mortgaged-backed securities, which are either self or tenant occupied may be given 50% risk weight of the corresponding ABS .

vi. Banks and Financial Institutions investing in the ABS/MBS will get exposed to the pool of assets/mortgages/obligors underlying such securities. The institutions therefore, should guard against concentrations of exposures to a particular industry/sector, institution or geographic area. In the case of a large number of underlying obligors, the exposure may be treated against this particular sector to which the pool of assets belong. In case there are one or two obligors, the exposure may be treated against those obligors. In case there are a few identifiable obligors, each of whom has the share of 25 per cent or more in the pool of assets, the exposure may be treated proportional against those borrowers. The FIs should take into accounts exposures through investments in securitised paper or combination of such paper with other credit exposures for the

purpose of complying with prudential guidelines on exposure to an individual borrower or a group.

vii) Income recognition and asset classification norms would apply to investment in securitised paper as per extant guidelines of RBI.

APPENDIX

Proposed Proforma of Reporting to Regulatory Authority for
<u>origination of Securitisation Scheme by Banks/FIs and NBFCs</u>

Name of the originating bank/FI/NBFC :

Full names , addresses of directors and names of the companies where they are directors :

Name and nature of SPV & details of relationship with originator (including constitution and shareholding pattern) :

Structure of SPV and its relationship with the trustee/administrator/servicer, if any :

Description and nature of asset transferred :

Carrying cost of assets transferred and % to total assets before transfer :

Method of transfer - Enclose a copy of the agreement/deed b/w originator and SPV (indicate, interalia, NOC from other creditors, consent of the obligors' etc.) :

Transfer consideration :
(Monetary and other)

Objects and economics of the securitisation offer :

Projected cash flow for the remaining tenor of the assets being securitised :

Proposed utilisation of amount realised by the originator (indicate how the rights of other creditors are protected especially for securitisation of assets in which other creditors have interest) :

The accounting treatment of the assets before and after securitisation :

Any existing charge on assets securitised and how it is proposed to be satisfied :

Classification (as per RBI norms) of assets transferred :

Amount and nature of credit enhancement provided (give details of all facilities provided viz. amount, duration, terms and conditions, enclose copy/ies of agreement) :

Any other facility viz. liquidity servicing/administration of assets,

underwriting provided (copy of agreement to be enclosed) :

CRAR of transferor :

	Before transfer	*After transfer*
Tier I		
Tier II		

Type and classes of securities issued by SPV
with ratings of each by approved rating agency :

Whether public issue or private placement :

Name and address etc. of holders of
5% or more of securities (if available) :

Names and addresses of other credit enhancers, liquidity
facility providers, servicer/administrator along with
description of facility, terms and condition of each facility :

Investment by originator in the securitised paper issuer wise :

Class of security	No. of securities held	Total amount

Total expenses incurred on the securitisation scheme :

Certificate of solicitor/chartered accountant
signifying true sale as per RBI guidelines :

Due diligence report of the merchant banker/
arranger/manager to the issue :

Details of hedging arrangements
IRS/currency swaps giving amount/due
date name of counter parties etc. :

Brief description (including diagrammatic representation of
the structure) of the scheme denoting cash and process flows :

Date and method of termination of the scheme
including mopping up of remaining assets :

Other documents to be enclosed:
Offer document, Prospectus, Servicing Agreement, Trustee
Agreement, financial valuation model provided to investors,

if any etc.(copies of drafts of all contracts between various
entities taking part in the transaction) :