

# Guidance Note On Accounting for Securitisation

(The following is the text of the Guidance Note on Accounting for Securitisation, issued by the Council of the Institute of Chartered Accountants of India.)

## INTRODUCTION

1. Securitisation is the process by which financial assets such as loan receivables, mortgage backed receivables, credit card balances, hire-purchase debtors, lease receivables, trade debtors, etc., are transformed into securities. Securitisation is different from 'factoring' in that 'factoring' involves transfer of debts without transformation thereof into securities. A securitisation transaction, normally, has the following features:

- Financial assets such as loan assets, mortgages, credit card balances, hire-purchase debtors, trade debtors, etc., or defined rights therein, are transferred, fully or partly, by the owner (the Originator) to a Special Purpose Entity (SPE) in return for an immediate cash payment and/or other consideration. The assets so transferred are the 'securitised assets' and the assets or rights, if any, retained by the Originator are the 'retained assets'.
- The SPE finances the assets transferred to it by issue of securities such as Pass Through Certificates (PTCs) and/or debt securities to investors.
- A usual feature of securitisation is 'credit enhancement', i.e., an arrangement which is designed to protect the holders of the securities issued by an SPE from losses and/or cash flow mismatches arising from shortfall or delays in collections from the securitised assets. The arrangement often involves one or more of the following:
  - *Provision of cash collateral*, i.e., a deposit of cash

which in specified circumstances can be used by the SPE for discharging its financial obligation in respect of the securities held by the investors.

- *Over collateralisation*, i.e., making available to the SPE assets in excess of the securitised assets, the realisation of which can be used in specified circumstances to fund the shortfalls and/or mismatches in fulfilment of its financial obligations by the SPE.
- *Recourse obligation* accepted by the Originator.
- *Third party guarantee*, i.e., a guarantee given by a third party by accepting the obligation to fund any shortfall on the part of the SPE in meeting its financial obligations in respect of the securitisation transaction.
- *Structuring of the instruments issued by an SPE into senior and subordinated securities* such that the senior securities (issued to investors) are cushioned against the risk of shortfalls in realisation of securitised assets by the subordinated securities (issued normally to the Originator). Payments on subordinated securities are due only after the amounts due on the senior securities are discharged.
- The Originator may continue to service the securitised assets (i.e., to collect amounts due from borrowers, etc.) with or without servicing fee for the same.
- The Originator may securitise or agree to securitise future receivables, i.e., receivables that are not existing at the time of agreement but which would be arising in future. In case of such securitisation, the future receivables are estimated at

the time of entering into the transaction and the purchase consideration for the same is received by the Originator in advance. Securitisation can also be in the form of 'Revolving Period Securitisation' where future receivables are transferred as and when they arise or at specified intervals; the transfers being on prearranged terms.

A diagrammatic presentation of a typical securitisation transaction is given in Appendix I.

2. This Guidance Note deals with accounting for securitisation transactions in the books of Originator, specially addressing issues such as when to derecognise, fully or partly, the securitised assets; treatment of securitisation of future receivables; measurement of consideration received in the form of securities; etc. The Guidance Note also deals with accounting for securitisation transactions in the books of SPEs. Another issue dealt with relates to accounting for investments in the securities such as PTCs and/or debt securities issued by the SPE, in the books of Investors.

### DEFINITIONS

3. The following terms are used in this Guidance Note with the meanings specified:

*Call Option* is an option that entitles the Originator to repurchase the financial assets transferred under a securitisation transaction from the SPE. The Option may be at a predetermined price or at a value to be determined, for example, fair value on the date of exercise of Call Option.

*Clean-up Call Option* is an option held by the servicer (who may be the Originator) to purchase the remaining transferred securitised assets or the remaining beneficial interests in the SPE if the amount of securitised assets or beneficial interests falls to a level at which the cost of servicing those assets or beneficial interests becomes burdensome in relation to the benefits of servicing.

*Interest Strip* is a contractual arrangement to separate the right to all or part of the interest due on a debenture, bond, mortgage loan or other interest bearing financial asset from the financial asset itself.

*Investor* is the person who finances the acquisition of the securitised assets or of beneficial interest therein by subscribing to PTCs and/or debt securities issued

by an SPE.

*Originator* is an entity that owns the financial assets proposed to be securitised and initiates the process of securitisation in respect of such assets.

*Pass Through Certificates (PTCs)* are instruments acknowledging a beneficial interest in the securitised assets such that the payment of interest on such instruments and the repayment of the principal are directly or indirectly linked or related to realisations from the securitised assets.

*Principal Strip* is the right to the remainder of the financial asset net of all rights that have been stripped therefrom by one or more contractual arrangements such as by an Interest Strip.

*Recourse Obligation* is the obligation of the Originator to reimburse or compensate, fully or partly, the investors for, or otherwise bear the risk of, shortfalls, such as those, arising from:

- failure of debtors to pay or to pay when due; or
- pre-payments; or
- other defects in securitised financial assets.

*Servicing asset* is a contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges and other related revenues are expected to more than adequately compensate the servicer (who may be the Originator) for performing the services. A servicing contract can be either:

- undertaken together with selling or securitising the financial assets being serviced; or
- purchased or assumed separately.

*Special Purpose Entity (SPE)* is an entity which acquires the financial assets under securitisation and normally holds them till maturity. SPE is an independent entity, usually constituted as a trust though it may be constituted in other forms, for example, as a limited company, formed with small capital for the specific purpose of funding the transaction by issue of PTCs or debt securities.

### ACCOUNTING IN THE BOOKS OF ORIGINATOR

#### Derecognition of securitised asset

4. Securitised asset should be derecognised in the books of the Originator, if and only if, either by a single transaction or by a series of transactions taken as

a whole, the Originator loses control of the contractual rights that comprise the securitised asset. The Originator loses such control if it surrenders the rights to benefits specified in the contract. Determining whether the Originator has lost control of the securitised asset depends both on the Originator's position and that of the SPE. Consequently, if the position of either the Originator or the SPE indicates that the Originator has retained control, the Originator should not remove the securitised asset from its balance sheet.

5. The Originator has not lost control over the securitised asset, for example, where
  - (a) the creditors of the Originator are entitled to attach or otherwise deal with the securitised assets;
  - (b) the SPE does not have the right (to the extent it was available to the Originator) to pledge, sell, transfer or exchange for its own benefit the securitised asset;
  - (c) the Originator has the right to reassume control of the securitised asset except
    - (i) where it is entitled to do so by a Call Option, where such Call Option can be justified on its own commercial terms as a separate transaction between the SPE and the Originator, for instance, where the Call Option is exercisable at fair value of the asset on the date of exercise of the Option; or
    - (ii) where it is entitled to do so by a Clean-up Call Option.
6. Whether the Originator has lost control over the securitised asset should be determined on the basis of the facts and circumstances of the case by considering all the evidence available. It would be incorrect to hold that the derecognition criterion prescribed in paragraph 4 is not met in the following cases:
  - (a) The Originator continues to service the securitised asset. Such servicing by itself would not lead to a conclusion that the Originator has not lost control over the securitised asset.
  - (b) An obligation is cast on the Originator to repurchase the securitised asset at a predetermined price. Such an obligation is not an entitlement to reassume ownership available to the Originator. Notwithstanding such an obligation the securitised asset would be beyond the control of the Originator. The obligation accepted by the Originator should be accounted for in the man-

ner indicated in paragraph 10 of this Guidance Note. However, where the Originator is both entitled and obligated to repurchase the securitised asset at a pre-determined price, the Originator is not considered to have lost control over the securitised asset and, therefore, the same should not be removed from the balance sheet of the Originator.

7. On derecognition, the difference between the book value of the securitised asset and consideration received should be treated as gain or loss arising on securitisation and disclosed separately in the statement of profit and loss. On the other hand, if the derecognition criterion as prescribed in paragraph 4 is not met, the asset should continue to be recognised in the books of the Originator and consideration received for the asset so transferred, should be accounted for as a borrowing secured there against.
8. The consideration received in a form other than cash, e.g., securities issued by the SPE, should be measured at the lowest of the
  - (a) the fair value of the consideration;
  - (b) the net book value of the securitised assets; and
  - (c) the net realisable value of the securitised assets.

In case the consideration has been received partly in cash and partly in a form other than cash, the non-cash component of the consideration should be measured at the lowest of the

- (a) the fair value of the non-cash component;
- (b) the net book value of the securitised assets as reduced by the cash received; and
- (c) the net realisable value of the securitised assets as reduced by the cash received.

The fair value is the price that would be agreed upon between knowledgeable, willing parties in an arm's length transaction. Quoted market price in an active, liquid and freely accessible market, if available, is normally the best evidence of fair value. If quoted market price is not available, estimate of fair value may be based on the market prices of assets similar to those received as consideration. In case the market prices of similar assets are also not available, the estimate of fair value may be based on generally accepted valuation techniques such as the

present value of estimated future cash flows. These techniques would require estimates and assumptions about various matters such as estimates of future revenues, future expenses and assumptions about interest rates, defaults and likely prepayments. Some of these estimations, e.g., estimation of future cash flows and discount rates may present significant difficulties. It would be necessary to make the best estimate based on reasonable and supportable assumptions and projections. All available evidence should be considered in developing the requisite estimate and assumptions.

9. In case the securitised assets qualify for derecognition, the entire expenses incurred on the transaction, say, legal fees, etc., should be expensed at the time of the transaction and should not be deferred. Where the securitised assets do not qualify for derecognition and, therefore, the consideration received in respect thereof is treated as a secured borrowing, such expenses should either be amortised over the term of the secured borrowing or recognised immediately in the statement of profit and loss.
10. If a securitised asset qualifies to be derecognised as per paragraph 4 and the Originator has accepted recourse or similar obligation, e.g., the Originator has granted a Put Option at a predetermined price to the SPE, then the contingent loss, arising therefrom, should be accounted for as per Accounting Standard (AS) 4, 'Contingencies and Events Occurring After the Balance Sheet Date', issued by the Institute of Chartered Accountants of India. This would require that a provision be made for the contingent loss arising from the obligation, where the criteria specified in the Standard in this regard are satisfied.

### Future Receivables / Revolving Securitisation

11. Any purchase consideration received by the Originator on the securitisation of future receivables should be accounted for as an advance, since the assets proposed to be securitised would not be existing at the time of the agreement, but would arise in future. The cost of bringing these assets into existence would also be incurred in future. In such cases, the criterion for derecognition prescribed in paragraph 4 should be applied as and when the relevant assets come into existence. Till such time the amounts received, if any, on account of the proposed securitisation should be reflected as an advance. The

other requirements of the Guidance Note also apply, *mutatis mutandis*, in case of securitisation of future receivables.

12. In case of revolving period securitisation where financial assets are transferred as and when they come into existence or at specified intervals and the purchase consideration is paid to the Originator at the time of such transfer, all requirements of this Guidance Note, except paragraph 11, apply.

### Partial Derecognition

13. An Originator may transfer only a part of the financial asset in a securitisation transaction instead of transferring the complete asset. Such transfer may occur in two ways. One way is where a proportionate share of the asset is transferred. For example, the Originator may transfer a proportionate share of loan (including right to receive both interest and principal), in such a way that all future cash flows, profit/loss arising on loan will be shared by the Originator and the SPE in fixed proportions. A second way of transferring a part of a financial asset arises where the asset comprises the rights to two or more benefit streams, and the Originator transfers one or more of such benefit streams while retaining the others. For example, the Originator may securitise the Principal Strip of the loan while retaining the Interest Strip and Servicing Asset.
14. If the Originator transfers a part of a financial asset while retaining the other part, the part of the original asset which meets the derecognition criterion as set out in paragraph 4 should be derecognised whereas the remaining part should continue to be recognised in the books. Similarly, if any new interest has been created as a result of securitisation transaction, such as a Call Option, the new interest should be recognised in the books in accordance with the relevant accounting principles.
15. If the Originator transfers a proportionate part of the asset, the previous carrying amount of the asset is apportioned among the part transferred and the part retained on the basis of proportion transferred and proportion retained. For example, if the originator transfers 75% of an asset to the SPE, 75% of the carrying amount of the asset should be considered as securitised. Where the securitised part of the asset qualifies to be derecognised as per the requirements of paragraph 4, the entity would continue to recognise the remaining part of the asset at 25% of the car-

rying amount.

16. In case the asset comprises the rights to two or more benefit streams and one or more of such benefit streams is/are transferred while retaining the others, the carrying amount of such financial asset should be apportioned between the part(s) transferred and the part(s) retained on the basis of their relative fair values as on the date of transfer. The fair values of the parts should be determined on the basis described in paragraph 8. If fair value of the part of the asset that is retained cannot be measured reliably, that part should be valued at a nominal value of Re.1. Similarly, if any new financial asset, e.g., a call option, has been created as a result of securitisation transaction and its fair value cannot be measured reliably, initial carrying amount of the asset should be recognised at a nominal value of Re.1.
17. An example illustrating the computations and accounting treatment in case of partial derecognition is given in Appendix II to this Guidance Note.

## ACCOUNTING IN THE BOOKS OF SPECIAL PURPOSE ENTITY

18. The SPE should recognise the asset received under a securitisation transaction, if the Originator loses control over the securitised asset on the basis of the criterion prescribed in paragraph 4. The asset so received should be recognised at the amount of consideration, if the consideration has been paid in cash. In case the consideration has been paid in a form other than cash, e.g., securities, the asset so received should be recorded either at its intrinsic value or at the fair value of the consideration, whichever is more clearly evident. If both the values are equally evident the asset should be valued at the lower of the two values.
19. If the beneficial ownership in the securitised asset has not been transferred to the SPE or the Originator has not lost control over the asset as per the requirements of paragraph 4, the SPE should not recognise the asset received. In such a case, the consideration paid should be recorded as a lending secured against the financial asset received under securitisation transaction.
20. The amount received by the SPE on issue of PTCs or other securities should be shown on the liability side of the balance sheet, with appropriate description,

keeping in view the nature of securities issued.

## ACCOUNTING IN THE BOOKS OF THE INVESTOR

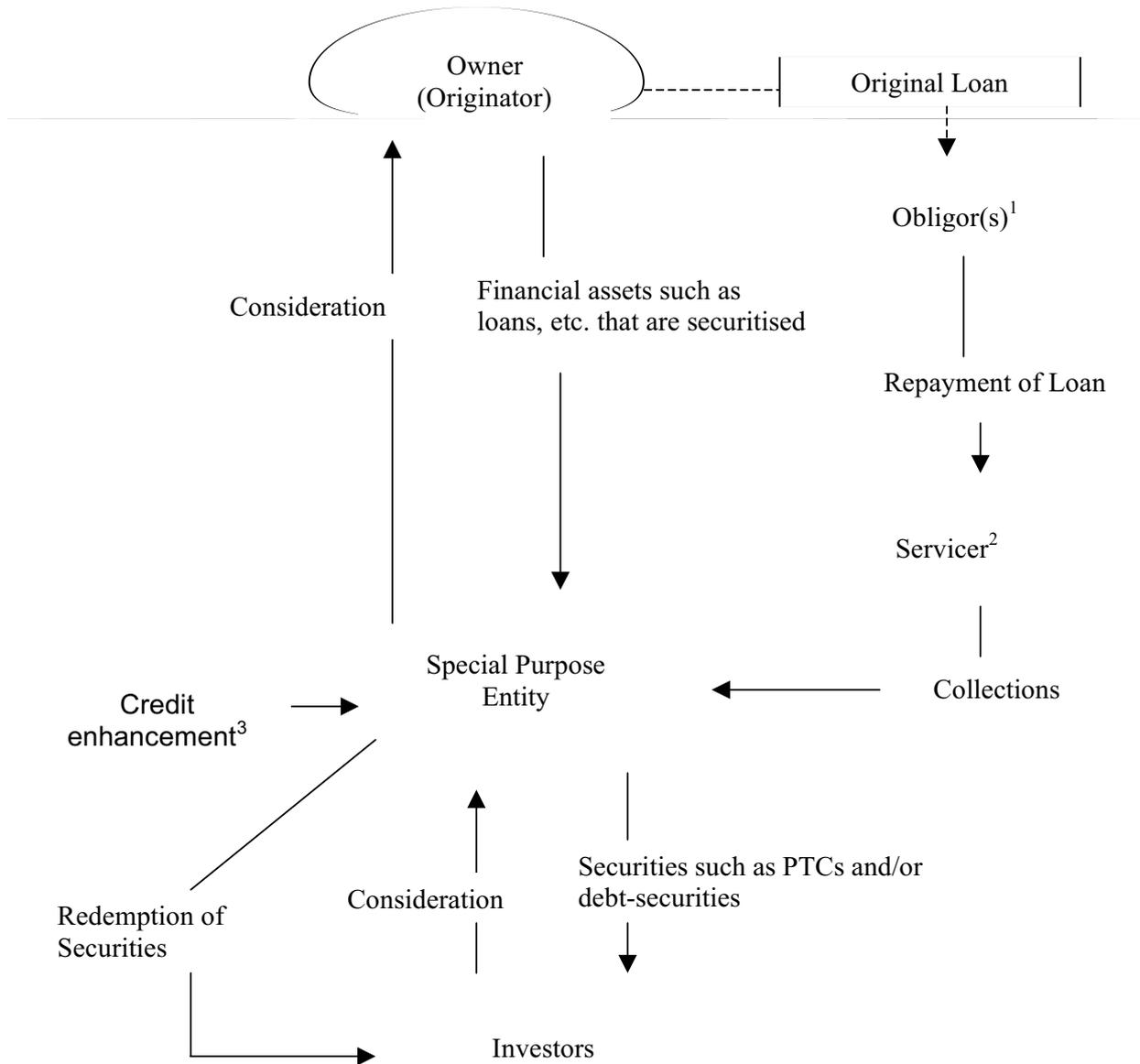
21. The Investor should account for the PTCs and/or debt securities acquired by it as an investment in accordance with Accounting Standard (AS) 13, 'Accounting for Investments'. However, where in case of an Investor, AS 13 is not applicable because of the Investor being specifically exempted from the application of AS 13, the investments in PTCs and/or other securities should be valued and accounted for as per the relevant accounting principles applicable to the Investor.

## DISCLOSURES

22. In addition to the disclosures arising from recommendations made in paragraph 10, the following disclosures should be made in the financial statements of the Originator:
  - (i) The nature and extent of securitisation transaction(s), including the financial assets that have been derecognised.
  - (ii) The nature and the amounts of the new interests created, if any.
  - (iii) Basis of determination of fair values, wherever applicable.
23. The following disclosures should be made in the financial statements of the SPE:
  - (i) The nature of the securitisation transaction(s) including, in particular, a description of the rights of the SPE vis-à-vis the Originator whether arising from the securitisation transaction or a transaction associated therewith.
  - (ii) Basis of determination of fair values, wherever applicable.
24. The Investor should make disclosure of investments in PTCs and/or debt securities as required by Accounting Standard (AS) 13, 'Accounting for Investments'. However, where in the case of an Investor, AS 13 is not applicable because the Investor is specifically exempted from the application of AS 13, the Investor should make such disclosures as per the relevant requirements.

*(This Appendix does not form part of the Guidance Note and is merely illustrative.)*

**Diagrammatic Presentation of a Typical Securitisation Transaction**



<sup>1</sup>Obligor is an entity which has received a loan giving rise to the financial asset that is securitised by the Originator

<sup>2</sup>can be the Originator also.

<sup>3</sup>may be provided either by the Originator or by any third party.

**Appendix II**

**Illustration of Computation and Accounting in Case of Partial Derecognition**

*(This Appendix does not form part of the Guidance Note and is merely illustrative.)*

- Suppose Company 'C' holds Rs. 1,000/- of loans yielding interest @ 18% p.a. for their estimated lives of nine years. Considering the interest rate the fair value of these loans is estimated at Rs. 1,100/-. The company securitises the principal component of the loan plus the right to receive interest @ 14% to an SPE for Rs. 1,000/-. Out of the balance interest of 4%, it is stipulated that half of such balance interest, namely 2%, will be due to the company as fees for continuing to service the loans. The fair value of the servicing asset so created is estimated, after taking into account the costs likely to be incurred in servicing the loan, at Rs. 40. The remaining half of the interest is due to the company as an interest strip receivable, the fair value of which is estimated at Rs. 60.
- Since the company has securitised the principal and a part of the interest, it is necessary to compute the cost attributable to various components assuming that the securitised components meet the derecognition criteria. This computation can be done by apportioning the carrying amount of the asset in the ratio of fair values as follows:

**Fair Value of securitised component of the loan**

Particulars	Rs.	Rs.
Fair value of loan		1,100
Less: Fair value of servicing asset	40	
Fair value of interest strip	60	100
Fair value of securitised component of loan		1,000

**Apportionment of carrying amount based on relative fair values**

Particulars	Fair Values	%age based on Total Fair Value	Carrying Amount / Cost
Securitised component of loan	1000	91	910
Servicing Asset	40	3.6	36
Interest Strip Receivable	60	5.4	54
	1,100	100	1,000

- The profit arising on securitisation should be computed as follows:

Net proceeds of securitisation	Rs. 1,000
Less: Cost (apportioned carrying amount) of securitised component of loan	910
Profit on securitisation	90

- Based on the above, the following journal entries would be passed in the books of the Originator:

		Rs.	Rs.
<i>(a) To record securitisation of principal plus right to 14% interest</i>			
Cash A/c	Dr.	1,000	
To Loans A/c (cost of securitised component)			910
To Profit on Securitisation			90
<i>(b) To record the creation of servicing asset and interest strip receivable</i>			
Servicing asset A/c	Dr.	36	
Interest strip A/c	Dr.	54	
To Loans A/c			90