Audit Of Investment And Securitisation Transactions

Understanding

Funds management department of the bank is one of the most sensitive and dynamic areas of a bank's operations. At any point of time it accounts for about 40% of the total financial resources and more than 55-60% of a bank's income. Rules and regulations are generally laid down governing the functioning of the activity by virtue of an Investment policy document duly approved by the Board, which is required to be in conformity with regulatory guidelines issued by Reserve Bank of India from time to time. The investments are categorised into SLR and non-SLR exposures. The SLR investments are required to be maintained on daily basis in Liquid assets and required to be reported to Reserve Bank of India on a fortnightly basis. Failure to maintain the required statutory minimum would not only entail in payment of penalty and interest for the shortfall but also the regulatory actions in the form of increased supervisory interventions and ultimate cancellation of banking licence. The investments that qualify for SLR are, Central Government and other approved Securities, Bonds Guaranteed by Central/State Governments, Excess CRR balances, Current balances with SBI and nationalised banks, Cash in hand. All other investments constitute non-SLR investments. The Reserve Bank of India has issued detailed guidelines on classification, valuation and operations of investment portfolio by banks. Specific guidelines are given in regard to Ready Forward (buy back) deals, Transactions through Subsidiary General Ledger A/c, Use of Bank Receipts, Retailing of Government securities, Internal Control System, Dealings through Brokers, Audit, Review and reporting. Detailed guidelines have also been issued by Reserve Bank of India in regard to exposure in non-SLR investments. The investment portfolios of banks (both SLR & non-SLR) are closely monitored by the Reserve Bank through the off site monitoring of returns (OSMOS) submitted by banks. Banks are required to classify all their investment exposures into three categories viz. 'Held to Maturity', 'Available for Sale' and 'Held for Trading'.

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Securitisation, is a process by which the future cash inflows of an entity (originator) are converted and sold as debt instruments called pay through or pass through certificates with a fixed rate of return to the holders of the debt instrument in the form of beneficial interest. The originator of a typical securitisation, transfers a portfolio of homogenous financial assets to a Special Purpose Vehicle (SPV), normally a trust. The SPV is basically funded by investors. In return for the transfer, the originator gets cash up-front on the basis of a mutually agreed valuation of the receivables. The transfer value of the receivables is done in such a manner so as to give the lenders a reasonable rate of return. In 'pass-through' and 'pay-through' securitisations, receivables are transferred to the SPV at the inception of the securitisation, and no further transfers are made. All cash collections are paid to the holders of beneficial interests in the SPV (basically the lenders).

Objective

The objective of Investments are statutory requirements and to deploy surplus liquidity and floats for generating optimum returns. The objectives of securitisation transactions are several, which inter alia include higher credit rating and cheaper borrowings. They can be done by conversion of existing or future cash in-flows of any entity i.e. loans, trade receivables, credit card receivables, rent etc. into tradable security. Securitisation can, at times, be used for better profitability. The importance of securitisation lies in the fact that it helps to convert illiquid assets or future receivables into current cash inflows and that too at a low cost. The company may sell the receivables in the market and raise loans. The guidelines on Securitisation of Standard assets vide DBOD.NO.BP.BC.60/21.04.048/2005-

06 (RBI guidelines) may be referred as and when required. It may be noted that these guidelines are applicable to bankers, financial institutions and non-banking financial companies.

Internal Control System

The auditors must ensure that the guidelines issued by the RBI in regard to the Internal Control System is strictly adhered to. There should be a clear functional separation of (i) trading, (ii) settlement, monitoring and control and (iii) accounting. Similarly, there should be a functional separation of trading and back office functions relating to bank's own Investment Accounts, Portfolio Management Scheme (PMS) Clients' Accounts and other Constituents (including brokers') accounts. For every transaction entered into, the trading desk should prepare a deal slip which should contain data relating to nature of the deal, name of the counter-party, whether it is a direct deal or through a broker, and if through a broker, then name of the broker, details of security, amount, price, contract date and time. The deal slips should be serially numbered and controlled separately to ensure that each deal slip has been properly accounted for. For PMS transactions separate serial number should be maintained. Once the deal is concluded, the dealer should immediately pass on the deal slip to the back office for recording and processing. For each deal there must be a system of issue of confirmation to the counter-party. The timely receipt of requisite written confirmation from the counter-party, which must include all essential details of the contract, should be closely monitored by the back office.

Transactions put through the NDS-OM module do not warrant counter-party confirmation. All other government securities transactions/deals would require physical confirmations by the counter party. On the basis of vouchers passed by the back office (which should be done after verification of actual contract notes received from the broker/counter-party and confirmation of the deal by the counter-party), the Accounts Section should independently write the books of account. It must be ensured that the counter party bank or the security purchased/sold should not be substituted. With regard to Subsidiary General Ledger (SGL) related transactions, the records of transfers must be maintained, the balances in bank's books must be matched with the statements received from the Public Debt Offices (PDOs) and reconciled on a quarterly basis. Before issue of SGL transfer forms covering their sale transactions, it should be ensured that sufficient balances are available in the respective SGL accounts. Under no circumstances should an SGL transfer form be issued in favour of another bank, resulting in bouncing back for want of sufficient balances. In such an event the selling bank issuing the form would be liable to penal action by RBI against it.

All Ready-forward deals in Government Securities including Treasury bills are prohibited. No ready-forward and double ready-forward deals should be put through in any security including government securities on behalf of portfolio management scheme (PMS) client's account or on behalf of other constituents including brokers.

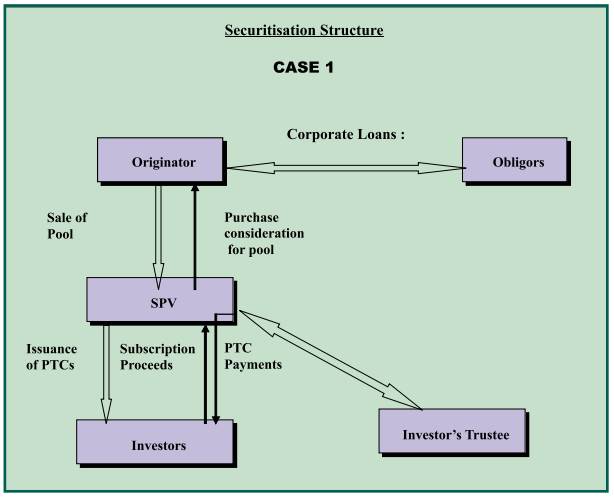
A record of BRs issued/received, which are serially numbered, should be maintained and a system for verification of the authenticity of the BRs and SGL transfer forms received from the other banks and confirmation of authorised signatories should be put in place. It should be ensured that no bank receipts are issued under any circumstances in respect of transactions in government securities for which SGL facility is available. No BR should be issued on the basis of a BR (of another bank) held by the bank and no exchange should take place on the basis of exchange of BRs held by the bank. No BR should remain outstanding for more than 15 days.

Banks should put in place a reporting system to report to the top management, on a weekly basis, the details of transactions in securities, details of bouncing of SGL transfer forms issued by other banks, BRs outstanding for more than 15 days, capital market exposures, a review of investment transactions undertaken during the period and overall risk management and internal controls.

The internal audit department should audit

the transactions in securities on an on-going basis, monitor the compliance with the laid down management policies and prescribed procedures and report the deficiencies directly to the management of the bank. In regard to securitisation transactions depending upon their categorisation i.e. if they are investments then the internal controls as referred hereinabove may be applied otherwise as applicable to advances may be applied.

Special Purpose Vehicle (SPV)



Securitisation transactions cannot be undertaken without an SPV. An SPV is an entity specially created for doing the securitisation deal. It invites investments from investors, uses the invested funds to acquire the receivables of the originator and then uses the realisations from the receivables transferred to it to pay the investors, thereby giving them a reasonable return. An SPV may be a trust, corporation, or any other legal entity. Its activities include holding title to transferred financial assets, issuing beneficial interest, collecting cash proceeds from assets held, reinvesting the proceeds in financial instruments pending distribution to the holders of beneficial interests and otherwise servicing the assets held. Generally, the beneficial interests in the qualifying SPV are sold to investors and the proceeds are used to pay the transferor for the assets transferred. Those beneficial interests may comprise either a single class having equity characteristics or multiple classes of interests, some having debt characteristics and others having equity characteristics.

The cash collected from the portfolio is distributed to the investors and others as specified by the legal documents that establishes the SPV.

- The process of securitisation of receivables normally has the following two stages, i.e. in the first stage there should be pooling and transferring of homogenous assets to a bankruptcy remote vehicle (SPV) and the second stage comprises of repackaging and selling the security interests represented by the claims on the incoming cash flows from the pool of assets, to the third party investors should be effected.
- The micro stages involved are:
  - i. The originator identifies the assets he wants to securitise for raising funds.
  - ii. The SPV is formed.
  - iii. The SPV is funded by investors and the SPV issues the securities to the investors. This referred to as financial closure
  - iv. The SPV acquires the receivables under an agreement at their discounted value.
  - v. The servicer for the transaction is appointed, normally the originator.
  - vi. The debtors are /are not notified depending on the legal requirements.
  - vii. The servicer collects the receivables, usually in an escrow mechanism and water fall arrangement, and pays off the collection to the SPV.
  - viii. The SPV either passes the collection to the investors, or reinvests the same to pay off to investors at stated pre-determined intervals.
  - ix. In case of default, the servicer takes action against the debtors as the SPV agent.
  - x. When only a small amount of outstanding receivables are left to be collected,

the originator may clean up the transaction by buying back the outstanding receivables.

xi. At the end of the transaction, the originator's profit, if retained and subject to any losses and expenses to the extent agreed upon by the originator, in the transaction is paid off.

Independent Assessment Of SPV

For ensuring the SPV remaining independent the auditors must ensure the following:

(i) The originating bank transferring the assets to the SPV should not hold any interest, direct or indirect in the Trustee Company. The originator should under no circumstances support losses of SPV. The Trust should be non-discretionary. The decision-making or the disguised substance that the originating bank continues to dominate the transactions must be identified. The transactions should be at arm's length, auditors would have a crucial role to play in ensuring that the comparable market quotations are available on records and the investment instruments (PTCs) are independently rated. SPV should adhere to transparency with regard to disclosures regarding constitution, ownership, capital structure, size of issue, terms of offer including interest payments/yield on instruments, details of underlying asset pool and its performance history, including details of the individual obligors, information about originator, transaction structure, service arrangement, credit enhancement details, risk factors etc. Regular updates to PTC holders about collection summary, Asset pool behaviour—delinquencies, losses, prepayment etc, Drawals from credit enhancements, Distribution summary, current rating of the PTCs and any other material / information relevant to the performance of the pool. Adequate disclaimers be made.

(ii) **True Sale Compliance:** For ensuring true sale of the pool by the Originator to the SPV, certain conditions with regard to establishment of transaction price based on market trends, no investments in the SPV except limited to 5 %, the originator should not have any interest or commitment whatsoever for repurchase of assets. Except clean up calls and non-maintenance of effective control over transferred assets, all risk and rewards should have been transferred along with the assets. The conditions relating to no formal recourse, no PUT/CALL options in respect of PTCs, no warranties by the originator or the bank, etc. must be adhered to and complied with. Certain exceptions particularly in respect of provision of certain non-core services may however be possible. These should be supported by opinion from the solicitors in respect of True Sale. The essence is that the assets should be put beyond the originator's as well as their creditors' reach, in the event of bankruptcy of the originator

(iii) **Classification:** All outflows and PTCs or share in securitised assets may be classified into Investments Or Advances. Generally these are instruments, which are independently realisable at will and classified as investments under non-SLR category.

The above investment should be carried in the books of the bank/FI at the price as determined above, until its ultimate sale or realisation, and on such sale or realisation, the loss or gain must be dealt with as under:

(i) If the sale to SC/RC is at a price below the net book value (NBV) (i.e. Book value less provisions held), the shortfall should be debited to the profit and loss account of that year.

(ii) If the sale is for a value higher than the NBV, the excess provision will not be reversed but will be utilised to meet the shortfall/loss on account of sale of other financial assets to SC/RC.

All instruments received by banks/FIs from SC/RC as sale consideration for financial assets sold to them and also other instruments issued by SC/RC in which banks/FIs invest, will be in the nature of non-SLR securities. Accordingly, the valuation,

classification and other norms applicable to investment in non-SLR instruments prescribed by RBI from time to time would be applicable to bank's/FI's investment in debentures/bonds/ security receipts/PTCs issued by SC/RC. However, if any of the above instruments issued by SC/RC is limited to the actual realisation of the financial assets assigned to the instruments in the concerned scheme the bank/FI shall reckon the Net Asset Value (NAV), obtained from SC/RC from time to time, for valuation of such investments.

There are exceptions where certain bonds or subscriptions to equities for projects are termed as Advances.

Sub-Classification

The entire investment portfolio of the banks (including SLR securities and non-SLR securities) should be classified under three categories viz. 'Held to Maturity', 'Available for Sale' and 'Held for Trading'. However, in the Balance sheet, the investments will continue to be disclosed as per the existing six classifications viz. a) Government securities, b) Other approved securities, c) Shares, d) Debentures & Bonds, e) Subsidiaries/ joint ventures and f) Others (CP, Mutual Fund Units, etc.). Banks should decide the category of the investment at the time of acquisition and the decision should be recorded on the investment proposals.

Held To Maturity:

The securities acquired by the banks with the intention to hold them up to maturity will be classified under Held to Maturity. (Banks are allowed to include investments included under 'Held to Maturity' category up to 25 per cent of their total investments). SLR securities upto 25 per cent of their Demand and Time Liabilities (DTL) as on the last Friday of the second preceding fortnight, Non-SLR securities included under HTM as on September 2, 2004, Fresh re-capitalisation bonds received by the bank from the Government of India towards their re-capitalisation requirement and held in their investment portfolio, Fresh investment in the equity of subsidiaries and joint ventures (holds more than 25 per cent of the equity) and RIDF/ SIDBI deposits.

Available For Sale & Held For Trading:

(i) The securities acquired by the banks with the intention to trade by taking advantage of the short-term price/ interest rate movements will be classified under Held for Trading. The securities which do not fall within the above two categories will be classified as 'Available for sale'

(ii) **Available For Sale:** The banks will have the freedom to decide on the extent of holdings under Available for Sale and Held for Trading categories. This will be decided by them after considering various aspects such as basis of intent, trading strategies, risk management capabilities, tax planning, manpower skills, capital position. The investments classified under Held for Trading category would be those from which the bank expects to make a gain by the movement in the interest rates/ market rates. These securities are to be sold within 90 days.

Shifting Among Categories: Banks may shift investments to/from Held to Maturity category with the approval of the Board of Directors once a year. Such shifting will normally be allowed at the beginning of the accounting year. No further shifting to/from this category will be allowed during the remaining part of that accounting year. Banks may shift investments from Available for Sale category to Held for Trading category with the approval of their Board of Directors/ALCO/ Investment Committee. In case of exigencies, such shifting may be done with the approval of the Chief Executive of the bank/Head of the ALCO, but should be ratified by the Board of Directors/ ALCO. Shifting of investments from Held for Trading category to Available for Sale category is generally not allowed. However, it will be permitted only under exceptional circumstances like not being able to sell the security within 90 days due to tight liquidity conditions, or extreme volatility, or market becoming unidirectional. Such transfer is permitted only with the approval of the Board of Directors/ALCO/Investment

Committee. Transfer of scripts from one category to another, under all circumstances, should be done at the acquisition cost/book value/market value on the date of transfer, whichever is the least, and the depreciation, if any, on such transfer should be fully provided for. Banks may apply the values as on the date of transfer and in case, there are practical difficulties in applying the values as on the date of transfer, banks have the option of applying the values as on the previous working day, for arriving at the depreciation requirement on shifting of securities.

Profit And Loss: All Profit on sale of investments should be taken to profit and loss account except in case of HTM which should be first taken to the Profit & Loss Account and thereafter be appropriated to the 'Capital Reserve Account'. Loss on sale to be always recognised in the Profit & Loss Account.

Audit, Review And Reporting Of Investment Transactions

The banks should follow the following instructions in regard to audit, review and reporting of investment transactions:

a) Banks should undertake a half-yearly review (as of 30 September and 31 March) of their investment portfolio, which should, apart from other operational aspects of investment portfolio, clearly indicate amendments made to the Investment Policy and certify adherence to laid down internal investment policy and procedures and Reserve Bank guidelines, and put up the same before their respective Boards within a month, i.e. by end-April and end-October.

b) A copy of the review report put up to the Bank's Board, should be forwarded to the Reserve Bank (concerned Regional Office of DBS) by 15th November and 15th May respectively.

c) Treasury transactions should be separately subjected to concurrent audit by internal auditors and the results of their audit should be placed before the CMD of the bank once every month. Banks need not forward copies of the above mentioned concurrent audit reports to Reserve Bank of India. However, the major irregularities observed in these reports and the position of compliance thereto may be incorporated in the half yearly review of the investment portfolio.

d) All securitisation transactions must be reviewed to ensure the following:

Controls over receivables on due dates, Ratio of non performing assets in the portfolio in relation to agreed % at the time of take-over (though RBI only permits securitisations of standard assets), maintenance and disclosure of cash collaterals, compliance with terms of agreement, availability of financials of SPV to assess value in books of investors in PTC and reports from collecting agent on recovery transferred to SPV.

Valuation

Held to maturity:

i) Investments classified under Held to Maturity category need not be marked to market and will be carried at acquisition cost, unless it is more than the face value, in which case the premium should be amortised over the period remaining to maturity.

ii) Banks should recognise any diminution, other than temporary, in the value of their investments in subsidiaries/joint ventures which are included under Held to Maturity category and should be provided for. Such diminution should be determined and provided for each investment individually.

Available For Sale: The individual scripts in the Available for Sale category will be marked to market at quarterly or at more frequent intervals. Securities under this category shall be valued scrip-wise and depreciation/appreciation shall be aggregated for each classification. Net depreciation, if any, should be provided for. Net appreciation, if any, should be ignored. Net depreciation required to be provided for in any one classification should not be reduced on account of net appreciation in any other classification. The book value of the individual securities would not undergo any change after

the marking to market.

Held For Trading: The individual scripts in the Held for Trading category will be marked to market at monthly or at more frequent intervals and provided for as in the case of those in the Available for Sale category. Consequently, the book value of the individual securities in this category would also not undergo any change after marking to market.

Investment Fluctuation Reserve: Banks have been advised to build up Investment Fluctuation Reserve (IFR) of a minimum 5 per cent of the investment portfolio within a period of 5 years.

Investment Reserve Account: In the event, provisions created on account of depreciation in the 'Available for Sale' or 'Held for Trading' categories are found to be in excess of the required amount in any year, the excess should be credited to the Profit & Loss account and an equivalent amount (net of taxes, if any and net of transfer to Statutory Reserves as applicable to such excess provision) should be appropriated to an Investment Reserve Account in Schedule 2 –"Reserves & Surplus" under the head "Revenue and other Reserves" and would be eligible for inclusion under Tier II within the overall ceiling of 1.25 per cent of total Risk Weighted Assets prescribed for General Provisions/ Loss Reserves. Banks may utilise Investment Reserve Account for provisions required to be created on account of depreciation in the AFS and HFT categories.

Market Value: The 'market value' for the purpose of periodical valuation of investments included in the Available for Sale and Held for Trading categories would be the market price of the scrip as available from the trades/quotes on the stock exchanges, SGL account transactions, price list of RBI, prices declared by Primary Dealers Association of India (PDAI) jointly with the Fixed Income Money Market and Derivatives Association of India (FIMMDA) periodically. In respect of unquoted securities, the procedure as detailed below should be adopted.

Unquoted SLR Securities: Central Government Securities—the prices/ YTM rates put out by the PDAI/ FIMMDA at periodical intervals. Treasury Bills should be valued at carrying cost.

State Government Securities—valued applying the YTM method by marking it up by 25 basis points above the yields of the Central Government Securities of equivalent maturity put out by PDAI/ FIMMDA periodically.

Other 'APPROVED' Securities—valued applying the YTM method by marking it up by 25 basis points above the yields of the Central Government Securities of equivalent maturity put out by PDAI/ FIMMDA periodically.

Unquoted Non-SLR Securities: Debentures/ Bonds—in the nature of advance should be valued on the YTM basis.

(i) Zero coupon bonds: Zero coupon bonds should be shown in the books at carrying cost, i.e., acquisition cost plus discount accrued at the rate prevailing at the time of acquisition, which may be marked to market with reference to the market value.

(ii) Preference Shares: The valuation of preference shares should be on YTM basis.

(iii) Equity shares: The equity shares in the bank's portfolio should be marked to market preferably on a daily basis, but at least on a weekly basis.

(iv) Mutual funds units: Investment in quoted Mutual Fund Units should be valued as per Stock Exchange quotations. Investment in un-quoted Mutual Fund Units is to be valued on the basis of the latest re-purchase price declared by the Mutual Fund in respect of each particular Scheme. In case of funds with a lock-in period, where repurchase price/ market quote is not available, Units could be valued at NAV. If NAV is not available, then these could be valued at cost, till the end of the lock-in period. Wherever the re-purchase price is not available the Units could be valued at the NAV of the respective scheme.

(v) Commercial Paper: Commercial paper should be valued at the carrying cost.

(vi) Investments in RRBs: Investment in RRBs is

to be valued at carrying Cost (i.e. book value) on consistent basis.

Investment In Securities Issued By SC/RC: All such investments to be valued at lower of cash consideration or redemption value of the investments.

Valuation\Provisioning Norms: When banks/FIs invest in the security receipts/pass-through certificates issued by Securitisation Company (SC)/Reconstruction Company (RC) in respect of the financial assets sold by them to the SC/RC, the sale shall be recognised in books of the banks/FIs at the lower of:

- the redemption value of the security receipts/pass-through certificates, and
- the NBV of the financial asset.
- the cash consideration paid.

The above investment should be carried in the books of the bank/FI at the price as determined above until its sale or realisation, and on such sale or realisation, the loss or gain must be dealt with as under:

(i) if the sale to SC/RC is at a price below the net book value (NBV) (i.e. Book value less provisions held), the shortfall should be debited to the profit and loss account of that year.

(ii) If the sale is for a value higher than the NBV, the excess provision will not be reversed but will be utilised to meet the shortfall/loss on account of sale of other financial assets to SC/RC.

All instruments received by banks/FIs from SC/RC as sale consideration for financial assets sold to them and also other instruments issued by SC/RC in which banks/FIs invest will be in the nature of non-SLR securities. Accordingly, the valuation, classification and other norms applicable to investment in non-SLR instruments prescribed by RBI from time to time would be applicable to bank's/FI's investment in debentures/bonds/security receipts/PTCs issued by SC/RC. However, if any of the above instruments issued by SC/RC is limited to the actual realisation of the financial assets assigned to the instruments in the concerned scheme of the bank/FI shall reckon the Net Asset Value (NAV), obtained from SC/RC from time to time, for valuation of such investments.

Non-Performing Investments

In respect of securities included in any of the three categories where interest/ principal is in arrears, the banks should not reckon income on the securities and should also make appropriate provisions for the depreciation in the value of the investment.

The banks should not set-off the depreciation requirement in respect of these non-performing securities against the appreciation in respect of other performing securities.

A non-performing investment (NPI), similar to a non-performing advance (NPA), is one where:

(i) Interest/instalment (including maturity proceeds) is due and remains unpaid for more than 90 days.

(ii) The above would apply mutates mutandis to preference shares where the fixed dividend is not paid.

(iii) In the case of equity shares, in the event the investment in the shares of any company is valued at Re.1 per company on account of the non availability of the latest balance sheet in accordance with the instructions contained in paragraph 28 of the Annexure to circular DBOD.BP.BC.32/ 21.04.048/ 2000-01 dated October 16, 2000, those equity shares would also be reckoned as NPI.

(iv) If any credit facility availed by the issuer is NPA in the books of the bank, investment in any of the securities issued by the same issuer would also be treated as NPI and vice versa. (v) The investments in debentures/ bonds, which are deemed to be in the nature of advance would also be subjected to NPI norms as applicable to investments.

State Government Guaranteed Investments: All investments in State Government guaranteed securities, including those in the nature of 'deemed advance', will attract prudential norms for identification of non-performing investments and provisioning, when interest/installment of principal (including maturity proceeds) or any other amount due to the bank remains unpaid for more than 90 days.

Income Recognition

Banks may book income on accrual basis on securities of corporate bodies/public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the Central Government or a State Government, provided interest is serviced regularly and as such is not in arrears.

Banks may book income from dividend on shares of corporate bodies on accrual basis provided dividend on the shares has been declared by the corporate body in its Annual General Meeting and the owner's right to receive payment is established.

Banks may book income from Government securities and bonds and debentures of corporate bodies on accrual basis, where interest rates on these instruments are pre-determined and provided the past interest is serviced regularly and is not in arrears.

Banks should book income from units of mutual funds on cash basis.

Conclusion

Since it is very difficult to condense all the provisions of the RBI guidelines in this article it would be desirable for the auditors examining the investment portfolio of a bank to be thoroughly familiar with these guidelines and also the bank's own policy document on investment before commencing the audit.

It would be fitting to conclude that Auditing is an art as well as a Science inasmuch as one needs to apply the principles to the actual realities in an innovative manner. While the regulatory prescriptions and bank's own policy guidelines form the boundaries within which the bank's investment operations are required and expected to be carried out, it is the auditing process that culls out and highlights the bubbles and weaknesses in the procedures adopted by the bank's operating personnel and forewarn the management about the likely risks which have the potential to undermine the Corporate Objectives of the bank. One can say that audit process is like the pebble of sand that enters the Pearl Oyster without whose irritation the Oyster will not be able to produce the Pearl. ❐