

**Query No. 20**

**Subject:** *Accounting for securitisation arrangement and investments in PTC securities.*<sup>1</sup>

**A. Facts of the Case**

1. A company (hereinafter referred to as ‘the Company’) is a systemically important non-deposit taking NBFC registered with the Reserve Bank of India (RBI). The Company is primarily engaged in retail lending to small road transport operators, small and medium entities (SMEs) and self-employed non-professionals by way of vehicle loans, loans against property and home loans. The portfolio comprises of predominantly vehicle finance loans, followed by loan against property and home loans. As on September 2021, the Company has total assets under management of Rs. 75,063 crore. Being into lending business, the Company sources funds from banks and debt market, commercial papers, working capital etc. The Company also sells receivables by way of securitisation and direct assignment in line with the relevant RBI guidelines for redeployment in lending activities.

*Securitisation transaction*

2. The querist has stated that securitisation is a process whereby commercial or consumer credits are packaged and sold in the form of financial instruments. A typical process of securitisation involves sale of specific receivables to a Special Purpose Vehicle (SPV) set up in the form of a trust or a company. The SPV in turn issues financial instruments (pass through certificates (PTCs), other debt instruments etc.) to the investors evidencing the beneficial ownership of the investors in the receivables. The financial instruments are rated by an independent credit rating agency. On the recommendation of credit rating agency, additional credit support is provided in order that the instrument may receive the desired level of rating. Typically, the servicing of the receivables is continued by the seller. Cash flows as and when they are received are passed onto the investors. Features of securitisation transactions include:

- (a) Absolute and valid sale of assets to an SPV (with defined purposes and activities) in trust for investors;
- (b) Reliance by the investors on the performance of the assets for repayment - rather than the credit of their Originator (the Seller) or the Issuer (the SPV);
- (c) Consequent to the above, ‘bankruptcy remoteness’ of the SPV from the Originator;
- (d) Support for timely payments, inter-alia, in the form of suitable credit enhancements;
- (e) Securitised debt paper usually achieves a high investment grade credit rating;
- (f) A special purpose trust is created and settled under a Trust Deed for acquiring the receivables in the nature of principal amount of the above loan facilities together with interest thereon, along with the rights and interest of the Originator in relation thereto including the security interests created over certain underlying assets under such loan facilities (collectively the ‘Assets’), as property of the Trust in trust and for the benefit of the investors, who subscribe to the pass through certificates issued by the Trust;

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<sup>1</sup> Opinion finalised by the Committee on 11.10.2022.

- (g) The issue proceeds received from the investors for subscribing to the PTCs, will be used by the Trust to pay to the sale consideration for the Assets acquired;
- (h) After acquiring the aforesaid Assets, the Trust will issue Series A PTC to the investors;
- (i) To meet the minimum retention requirement (MRR) stipulated by the Reserve Bank of India (RBI), in relation to the Assets being sold, the Originator shall, if required, subscribe to such number of Series A PTCs as required to comply with MRR and pay subscription monies for the said Series A PTCs;
- (j) The investors shall be entitled to obtain Series A Yield;
- (k) Seller (generally) is appointed as the Servicer in relation to the Assets, and in that capacity, the Servicer shall be entitled to collect (and take any enforcement proceedings in relation to) the Receivables for and on behalf of the Trust;
- (l) Claims or rights of the Investors to receive payment of the Receivables shall rank *pari passu inter se* and there shall be no difference in the rights, title and interest between the Investors, irrespective of the date on which the Application Money shall have been paid by them;
- (m) Each PTC will evidence the PTC holder's respective pro rata share and undivided beneficial interest in the underlying Assets on a *pari passu* basis with other PTC holders;
- (n) The Seller will have the option to repurchase the Receivables pertaining to the performing contracts any time after the outstanding Receivables decline below 10% (Ten Percent) of the initial Receivables, at a purchase consideration equal to the outstanding principal amount. The exercise of this option would have the same effect as Prepayments for the purposes of making Investor Pay outs to the Beneficiaries under the Deed of Assignment.

The Company has sold Rs. 471.70 crore of principal outstanding receivables for a purchase consideration at par to a special purpose vehicle named, P Trust in March 2021, (hereinafter referred to as 'the Trust') created and settled by the Trustee under securitisation route. The Trust has issued 4,716 PTC (nos.) of face value of Rs. 10 lakhs each to the investors and the Company has also subscribed 7% of Principal outstanding (i.e., 33.10 crore or 331 PTCs of Rs. 10 lakh each) in order to comply MRR, stipulated by the RBI. On the deal date of transferring receivables, the Company has transferred Rs. 33.10 crore to Trust bank account and so shall all other investors subscribe to the information memorandum of the Trust. Finally, the Company received Rs. 471.70 crore as purchase consideration from the Trust for securitising the receivables. Henceforth, the Company shall operate as the servicing agent and pass on monthly collections of the underlying securitised receivables and the Trust in turn shall settle the obligation to the investors duly and remit the balance, if any, on collections back to the Company on satisfaction of the monthly obligations.

### 3. *Accounting under Indian Accounting Standard (Ind AS)*

According to the querist, the receivables sold by way of securitisation do not meet the derecognition criteria of substantial transfer of all risks and rewards under Ind AS 109, 'Financial Instruments' as the credit enhancement provided is higher than the expected credit loss for the pool of receivables. Hence, the sale consideration received is treated as borrowings and disclosed as a separate line item in the financial statements under

'Borrowings (other than debt securities)'. Credit enhancement provided by way of fixed deposit with banks is disclosed separately as part of bank balances other than cash and cash equivalents. Investment in 'Pass through Certificates (PTC)' issued by the Trust acquiring the receivables to comply with minimum retention requirements of RBI guidelines is netted off against securitisation borrowings in the financial statements with appropriate note. The investment in PTC is netted off and presented in the financial statements considering the following aspects:

- Investments in PTCs which are further invested in the underlying loans will be settled by the Trust only based on recovery of the loan. These investments are only pass through in nature and does not represent a standalone asset having cash generation capability.
- As per the arrangement with the Trust and terms of the investments, the PTCs are repaid to the investor at same interval as of the repayment of borrowing (linked to collection from underlying loans). Accordingly, there is insignificant credit and liquidity risk, and that will process receivable from investment in PTC and payment for securitisation loan in a single settlement cycle.
- Considering substance over form, the PTC asset generates cash flows from the repayment of securitisation borrowings (including interest) which continues to be recognised on the Company's balance sheet. If the set off is not done, the assets may be artificially inflated with underlying for both assets representing a single asset / loan.

Further, it is to be noted that investments in PTC is a necessary condition (assumed by the Company) for receipt of sale consideration as the Trust (set up exclusively for this transaction) will not be able to pay to this extent otherwise; the PTCs are redeemed by the Trust only out of the collections made and passed on by the Company in respect of the pool of receivables sold. The Trust is under no obligation to redeem the PTCs except out of the moneys realised from the pool of receivables through regular collection or enforcement action.

The sale consideration thus received includes the payment made by the Company towards PTC subscription. The above accounting treatment and disclosure for PTCs are in place since adoption of Ind AS in the financial year 2017-18. However, other companies in the industry are adopting varied practices.

## **B. Query**

4. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee on the following issues, as it is believed that the existing disclosure for PTCs (net off against securitisation borrowing) is in line with Ind AS 109 and also complies with the basic principle of substance over form:

- (a) Whether the Company can continue to net off PTCs against securitisation borrowings for disclosure in the financial statements.
- (b) If the answer to the above is negative, how should the PTC investments be disclosed?

## **C. Points considered by the Committee**

5. The Committee notes that the basic issue raised by the querist relates to presentation and disclosure of investments in PTCs and securitisation borrowings in the Balance Sheet. The Committee has, therefore, examined only this issue and has not examined any other issue

that may arise from the Facts of the Case, such as, accounting by the Trust, impairment (if any) of receivables as per the requirements of Ind AS 109, accounting for credit enhancements, whether there is need for consolidation of the Trust by the Company, accounting in the consolidated financial statements (if any), accounting for call option held by the Company to repurchase the receivables any time after the outstanding balance on the pool of receivables declines below 10% of the initial pool balance, detailed presentation and disclosure requirements of Ind AS 107, 'Financial Instruments: Disclosures' and Ind AS 109 with regard to the securitisation transaction, etc. Further, the opinion expressed is purely from the accounting perspective and not from the perspective of legal interpretation of Trust Deed, Information Memorandum, Deed of Assignment of Receivables, various relevant RBI regulations and directives, etc. including compliances with legal and regulatory aspects.

6. The Committee further notes that securitisation arrangement in the extant case involves sale of specific receivables of the Company to a special purpose vehicle, i.e., the Trust, which in turn issues pass through certificates (PTCs) to the investors evidencing the beneficial ownership of the investors in the receivables. The Company has also subscribed to PTCs to the extent of 7% of principal outstanding, in order to comply with MRR, stipulated by the RBI. In the context of the above-mentioned sale of receivables, which are financial assets as per the requirements of Ind AS 32, 'Financial Instruments: Presentation', the Committee notes that the Company has not derecognised these financial assets in its financial statements. In this regard, the Committee wishes to state that the detailed requirements with regard to derecognition of financial assets are enunciated in Ind AS 109, 'Financial Instruments'. The Committee presumes that the Company has complied with these requirements and accordingly, the Committee has not examined the appropriateness of non-derecognition of receivables and recognition of securitisation borrowings in the financial statements of the Company.

7. With regard to the issue that whether the financial liability arising from the sale proceeds/consideration of the securitised receivables and the amount of the Company's investment in PTCs can be netted off, the Committee notes that paragraph B3.2.14 of Ind AS 109 states as follows:

“B3.2.14 To the extent that a transfer of a financial asset does not qualify for derecognition, the transferor's contractual rights or obligations related to the transfer are not accounted for separately as derivatives if recognising both the derivative and either the transferred asset or the liability arising from the transfer would result in recognising the same rights or obligations twice. For example, a call option retained by the transferor may prevent a transfer of financial assets from being accounted for as a sale. In that case, the call option is not separately recognised as a derivative asset.”

From the above, the Committee notes that Ind AS 109 prohibits separate recognition of a transferor's contractual rights related to the transfer of a financial asset to the extent the same does not qualify for derecognition, as it results in recognising the same rights twice. For example, a call option retained by the transferor, which prevents a transfer of financial assets from being accounted for as a sale, is not separately recognised as a derivative asset. Although the above-reproduced paragraph of Ind AS 109 specifically deals with recognition of contractual rights as derivative, drawing an analogy from this, the Committee is of the view that a similar approach should be taken in respect of contractual rights associated with a non-derivative financial instrument, such as the PTC investments in the extant case, issued to the transferor by the transferee in relation to the transfer of financial asset (receivables) that does

not qualify for derecognition. This is so because, in the extant case, since the underlying receivables are not derecognised by the Company on the basis of its analysis under Ind AS 109, separate recognition of the Company's investments in PTCs (which represent, in substance, the same cash flows as the underlying receivables), in addition to the underlying receivables that continue to be recognised in the Company's financial statements, would result in recognising the same underlying rights twice.

On the basis of above discussion, the Committee is of the view that in the extant case, investments in PTCs held by the Company and equivalent securitisation borrowing (financial liability) should not be recognised as separate financial instruments. An entity cannot recognise a financial asset where it is itself the obliged counterparty. Accordingly, the question of set-off of securitisation borrowing and investment in PTC does not arise. The remaining securitisation borrowings (financial liabilities) other than those represented by the PTCs held by the Company, should continue to be recognised separately.

Further, in the above context, the Committee wishes to point out that since the Company has continuing involvement in the transferred financial asset (receivables) and has obtained new contractual rights relating to the transferred asset in the form of PTCs as per MRR of the RBI, the Company should comply with the disclosure requirements as per paragraphs 42A to 42H of Ind AS 107, 'Financial Instruments: Disclosures'. Furthermore, considering the disclosure objectives as per Ind AS 1, 'Presentation of Financial Statements', the Company should provide additional disclosures in the Notes to Accounts so as to present true and fair view of the financial position, financial performance and cash flows of the Company.

**D. Opinion**

- 8. On the basis of the above, the Committee is of the opinion that:
  - (a) In the extant case, the Company's investment in PTC and equivalent securitisation borrowing (financial liability), shall not be recognised as separate financial instruments, as discussed in paragraph 7 above and hence, the question of set-off of securitisation borrowing (financial liability) and investment in PTC does not arise. The remaining securitisation borrowings (financial liability) other than those represented by the PTCs held by the Company should continue to be recognised separately.
  - (b) Refer (a) above. The Company should also provide additional disclosures as per the requirements of Ind AS 107 and Ind AS 1, as discussed in paragraph 7 above.

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