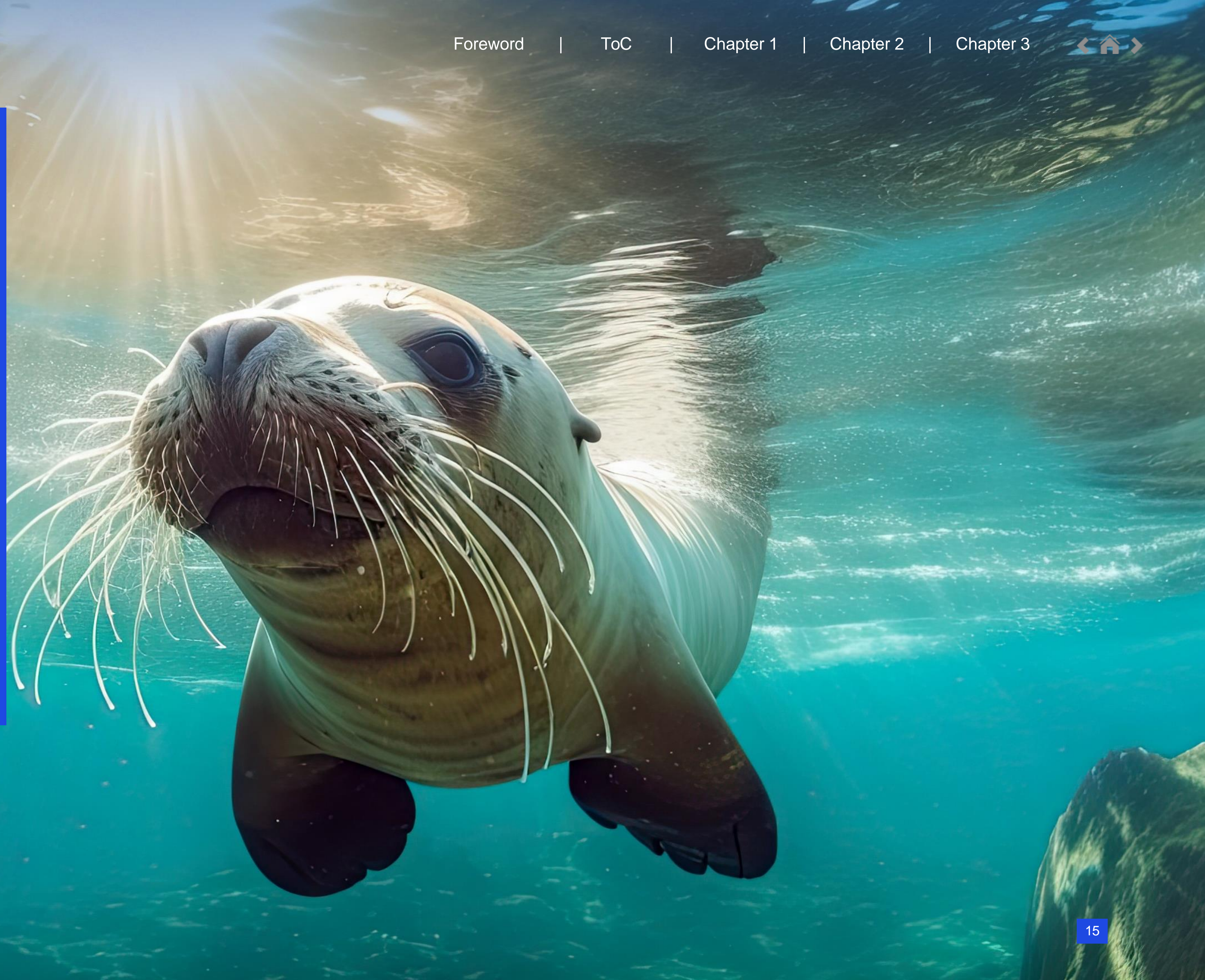
CHAPTER 2

Securitisation arrangement involving investments in Pass Through Certificate (PTC) securities

This article aims to:

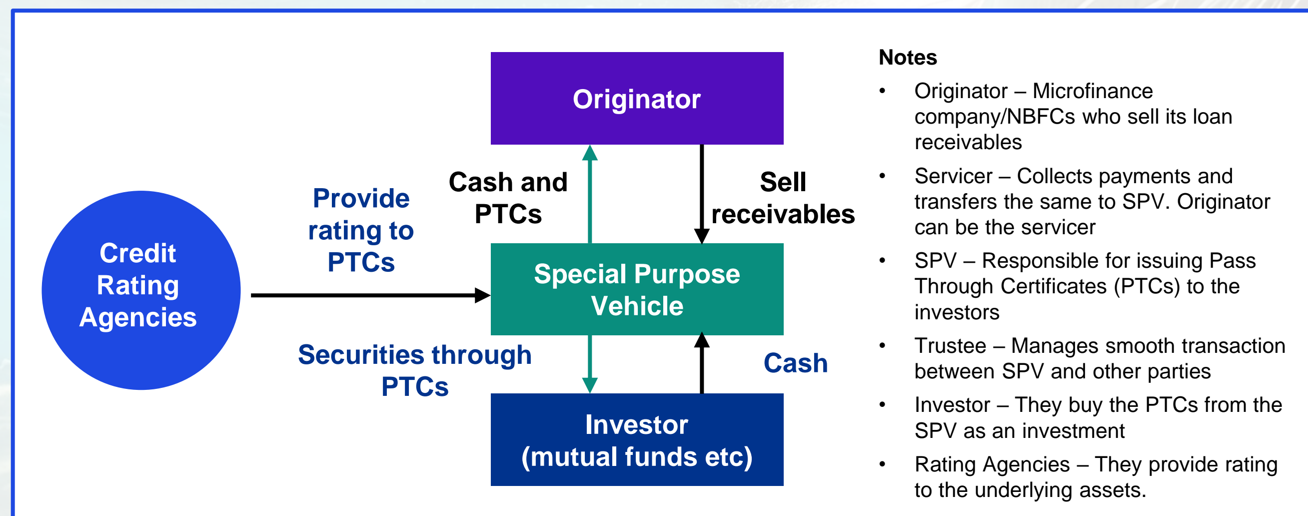
Provide guidance on the presentation and disclosure of investments in PTCs and covers a recent EAC opinion issued on the same topic.



Introduction

Entities commonly use securitisations to monetise financial assets - such as homogeneous consumer loans, credit card receivables, trade receivables or mortgage loans - by selling newly created securities collateralised by these financial assets to investors. Such securitisation transactions are often executed using structured entities that have limited activities. The purpose of the structured entities is to hold the interests in the securitised financial assets and to pass through cash flows earned on these financial assets to the investors in the securities issued by the structured entities. In a typical securitisation, the transferring entity assigns financial assets to the structured entity in return for cash proceeds. The transfer of financial assets, issue of notes to investors and payment of proceeds to the transferor usually take place simultaneously. Figure 1 below, depicts a typical securitisation arrangement.

Figure 1 – A typical securitisation arrangement



(Source: KPMG in India's analysis, 2024)

If financial assets are securitised using a structured entity, then determining whether those financial assets should be derecognised may be a complex issue and would need further assessment of the principles enunciated in Ind AS 109, *Financial Instruments.* In many securitisation transactions involving structured entities, the pass-through requirements will be difficult to achieve or will not be met. In addition, because the purpose of a securitisation is often to raise highly rated, low-cost finance, the transferor typically provides some form of credit enhancement to the structured entity. For example, the transferor may provide additional collateral to the structured entity in the form of loans or cash, or may provide a guarantee to the investors in the securities issued by the structured entity.

The Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI) deliberated on the accounting and disclosure of the sale consideration received from **the SPV and the investment in PTCs by the originator under a securitisation arrangement**[1]. This article aims to discuss some of the key factors discussed by the EAC in reaching its opinion.

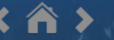
Facts of the case

The originator is a Non-Banking Financial Company (NBFC) primarily into retail lending (the company or the originator). In order to source funds for carrying out operations and managing liquidity, it uses the securitisation route by selling its loan receivables at par to an SPV. The SPV, created in the form of a trust, has issued PTCs to the investors for raising funds to pay the purchase consideration of the receivables. The company has provided a fixed deposit to the SPV as a credit enhancement for this arrangement.

In order to comply with the MRR, the company has also **subscribed to the PTCs representing seven per cent of the principal outstanding.** On the deal date of transferring receivables, the company transferred its subscription amount to the trust bank account and has received the full purchase consideration from the trust for securitising the receivables.

1. The Reserve Bank of India, in the Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021 also mandates originators to procure a certain portion of the PTCs issued by the structured entities as Minimum Retention Requriement (MRR).

© 2024 KPMG Assurance and Consulting Services LLP, an Indian Limited Liability Partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.



The company, in this arrangement, continues to service the receivables and is responsible for passing on the monthly collections of the underlying securitised receivables to the trust. Each PTC evidences 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.

In the financial statements of the company:

- The sale consideration received from the SPV for the loan portfolio is treated as borrowings and disclosed as a separate line item in the financial statements
- 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 PTCs is netted off against securitisation borrowings in the financial statements with an appropriate disclosure note.

The query relates to the above-mentioned presentation and disclosure of investments in PTCs and securitisation borrowings in the financial statements of the originator.

Analysing the EAC opinion

The above mentioned case may be evaluated in the following sections:

A. Derecognition of loan by the company

As per Ind AS 109, the assessment for derecognition of financial assets is generally applied to the consolidated financial statements of an entity as it avoids the unnecessary consideration of transactions between individual entities in a group, the effect of which is eliminated on consolidation[2]. However, for the purpose of this article, we will apply these principles to the separate financial statements of the originator.

Key considerations

When derecognition is assessed at the consolidated level, the issue of whether the transferring entity (the transferor) consolidates the receiving entity transferee). This fact has a significant impact on the accounting.

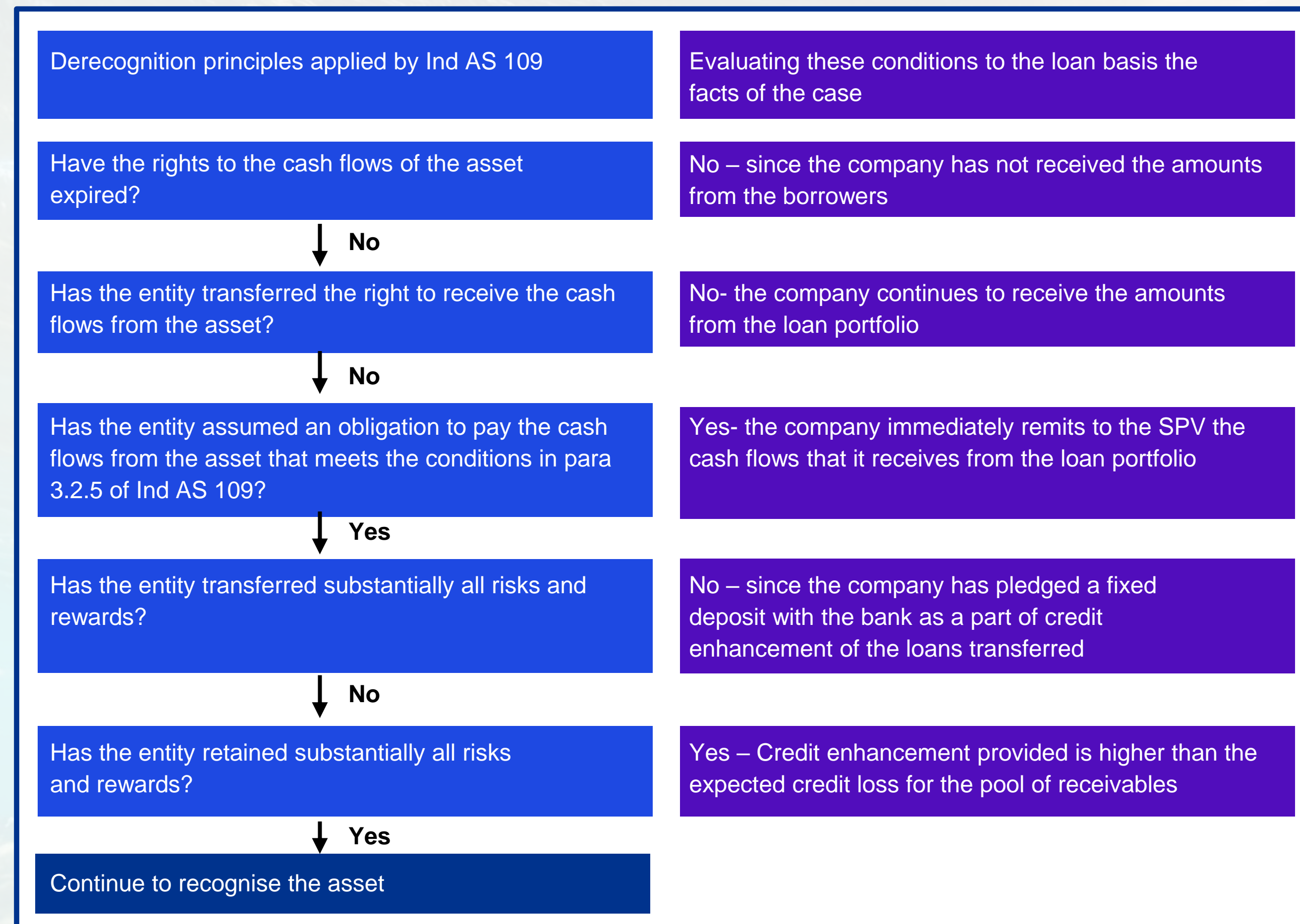
A detailed assessment of whether the financial statements of the SPV and the originator will be consolidated needs to be performed.

2. If financial instruments are transferred within a group, then the consolidated financial statements will not reflect derecognition for intra-group transfers, even if those transfers qualify for derecognition in the individual financial statements of the entity that is the transferor.

© 2024 KPMG Assurance and Consulting Services LLP, an Indian Limited Liability Partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

While the EAC opinion has assumed that the derecognition criteria is not met, let us assess the rationale of the conclusion reached, in figure 2 as below:

Figure 2: Assessment of the derecognition principles to the facts of the case



(Source: KPMG in India's analysis, 2024, read with Insights into IFRS- 20th edition, issued by KPMG IFRG in September 2023)

Analysis of figure 2

The company has transferred its loan portfolio to the SPV, accordingly, the rights to the cash flows from the loan portfolio have not expired. However, the company continues to service the loan- i.e. it collects the amounts from the borrowers and immediately remits it to the SPV. The manner in which it services these loans meet the criteria prescribed in para 3.2.5 of Ind AS 109[3].

The company has also provided a fixed deposit as a credit enhancement to the SPV, accordingly, in case of any cash shortfalls (or shortfalls in collection of amounts by the company), the SPV can liquidate the fixed deposit to meet its obligations to the investors of the PTCs. In most cases, evaluating the terms and conditions of the transaction should be enough to determine whether, and to what extent, an entity's exposure to variability in the amounts and timing of the net cash flows has changed as a result of the transfer. Accordingly, generally it is not necessary to use cash flow and/or similar models in performing a risks and rewards analysis. However, under certain circumstances a degree of statistical analysis might be required. For example, in transactions in which the transferor and the transferee share the exposure to the variability in cash flows arising from credit risk, it might be difficult to determine whether substantially all of the risks and rewards have been transferred.

In the current case, the company has pledged its fixed deposits with the SPV for the payments pertaining to the loan portfolio. As per the company's analysis, the credit enhancement provided is higher than the expected credit loss for the loan portfolio. Accordingly, the company has concluded that it has retained substantially all risks and rewards pertaining to the portfolio of loans. Thus, this loan portfolio would not qualify for derecognition.

3. As per para 3.2.5 of Ind AS 109, when an entity retains the contractual rights to receive the cash flows of a financial asset, but assumes a contractual obligation to pay those cash flows to one or more entities, the entity treats the transaction as a transfer of a financial asset if, and only if, all of the following three conditions are met:
- The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset.
- The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset
- The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay.

© 2024 KPMG Assurance and Consulting Services LLP, an Indian Limited Liability Partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

Derecognition analysis for securities with different rights

In the current case analysed by the EAC, the securities issued by the SPV carry equal rights and are pari pasu. However, in many cases, in a securitisation arrangement, SPVs issue securities with differential rights- i.e. superior securities or subordinate securities.

A. Superior securities

Superior securities are securities that have superior rights as compared to other securities. So for example, where the SPV allocates superior securities to the originator, then the originator would have the right to the initial payment of the amounts collected by the SPV from the loan portfolio. In such a case, the originator would not be liable to bear a loss, and thus generally, it could be concluded that the risks and rewards in the transactions have been transferred, and generally the loan portfolio transferred to the SPV would qualify for derecognition.

B. Subordinate securities

Subordinate securities are securities that are subordinate to or are junior most as compared to other securities. So for example, where the SPV allocates subordinate securities to the originator, then the SPV would make the initial payments of the amounts collected from the loan portfolio to holders of the superior securities, and latter payments to the holders of subordinate securities. Where amounts have not been collected from the loan portfolio, then the holders of subordinate securities would have to bear the loss. In such cases, generally, it could be concluded that the risks and rewards in the transactions have **not been transferred,** and generally the loan portfolio transferred to the SPV would **not qualify for derecognition.**

However, further analysis would be required to additional facts and circumstances involved in each of the these cases to conclude on the derecognition requirements.

B. Accounting for investments in PTCs

I. Accounting for sale consideration received from SPV

As per Ind AS 109, if a transfer does not qualify for derecognition, then the financial asset, or the retained portion of the financial asset, remains in the statement of financial position and a corresponding financial liability is recognised for any consideration received.

Since the company has not derecognised the financial assets in its books of accounts, it has correctly accounted for the consideration received for the transfer of the loan portfolio to the SPV as a liability under ‘Borrowings’ in its financial statements.

II. Accounting for investment in PTCs

Ind AS 109 further specifies that in case a transfer of 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 such transfer would result in recognising the same rights or obligations twice.

The EAC has drawn an analogy from the above in case of non-derivative financial instruments, to conclude 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.

© 2024 KPMG Assurance and Consulting Services LLP, an Indian Limited Liability Partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

In the current case, since the underlying receivables are not derecognised by the company, separate recognition of its investments in PTCs (which represent, in substance, the same cash flows as the underlying receivables) would result in recognising the same underlying rights twice.

Based on an evaluation of the facts of the case, the EAC opined that an entity cannot recognise a financial asset where it is itself the obliged counterparty. Therefore the investments in PTCs and the equivalent securitisation borrowing should not be recognised as separate financial instruments.

The balance securitisation borrowing (other than those represented by the PTCs held by the originator) should continue to be recognised separately.

C. Disclosure of the arrangement in the financial statements

The EAC reiterated that given the continued interest of the originator in the transferred financial asset (receivables) and its investment in the PTCs as per the MRR stipulated by the RBI, the originator should comply with the disclosure/additional disclosure requirements of Ind AS 107, *Financial Instruments: Disclosures* [4] and Ind *AS* 1, *Presentation of Financial Statements* [5] respectively.

Conclusion

Entities should provide detailed and appropriate disclosures explaining the nature and impact of these arrangements in the financial statements.

4. Para 42A to para 42H of Ind AS 107 prescribe the disclosure requirements pertaining to transfer of financial assets.
5. Para 15 of Ind AS 1 prescribes that financial statements should present a true and fair view of the financial position, financial performance and cash flows of an entity. Presentation of true and fair view requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Conceptual Framework for Financial Reporting under Indian Accounting Standards issued by ICAI. The application of Ind ASs, with additional disclosure when necessary, is presumed to result in financial statements that present a true and fair view.

© 2024 KPMG Assurance and Consulting Services LLP, an Indian Limited Liability Partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.