Derecognition and consolidation requirements in a securitisation transactions

This article aims to:

- Explain the derecognition and consolidation requirements in a securitisation transactions.

Summary

Banks and Non-Banking Financial Companies (NBFCs) often enter into securitisation transactions to generate liquidity, facilitate capital relief and redistribute credit risks to a certain extent. Currently, these entities derecognise securitised loans from their balance sheet if legal 'true sale' criteria as specified by the Reserve Bank of India (RBI) are met. Further, trusts or other Special Purpose Vehicles (SPV) set up for the securitisation are generally not consolidated based on the guidance in Accounting Standard (AS) 21, *Consolidated Financial Statements*.

On transition to Ind AS, banks would have to apply the guidance in Ind AS 110, *Consolidated Financial Statements* to determine whether such SPVs should be consolidated. Further, the derecognition of securitised loans from the banks' separate as well as consolidated financial statements would be determined by guidance in Ind AS 109, *Financial Instruments*. Most securitisations require the originating banks to provide support in the form of credit enhancement and grant banks the right to any excess returns. These features generally fail the derecognition tests in Ind AS 109 and result in continued recognition of the securitised assets by the originating bank. This may also affect the bank's ability to obtain capital relief by entering into these structured transactions.

While banks are exempt from applying the derecognition guidance to past securitisations (completed prior to the Ind AS transition date), no such exemption is available for consolidation. Consequently, banks would not have to recognise loans securitised prior to transition on their separate balance sheet, but may have to consolidate the securitisation SPV. This would result in such loans being brought back on the consolidated balance sheet.

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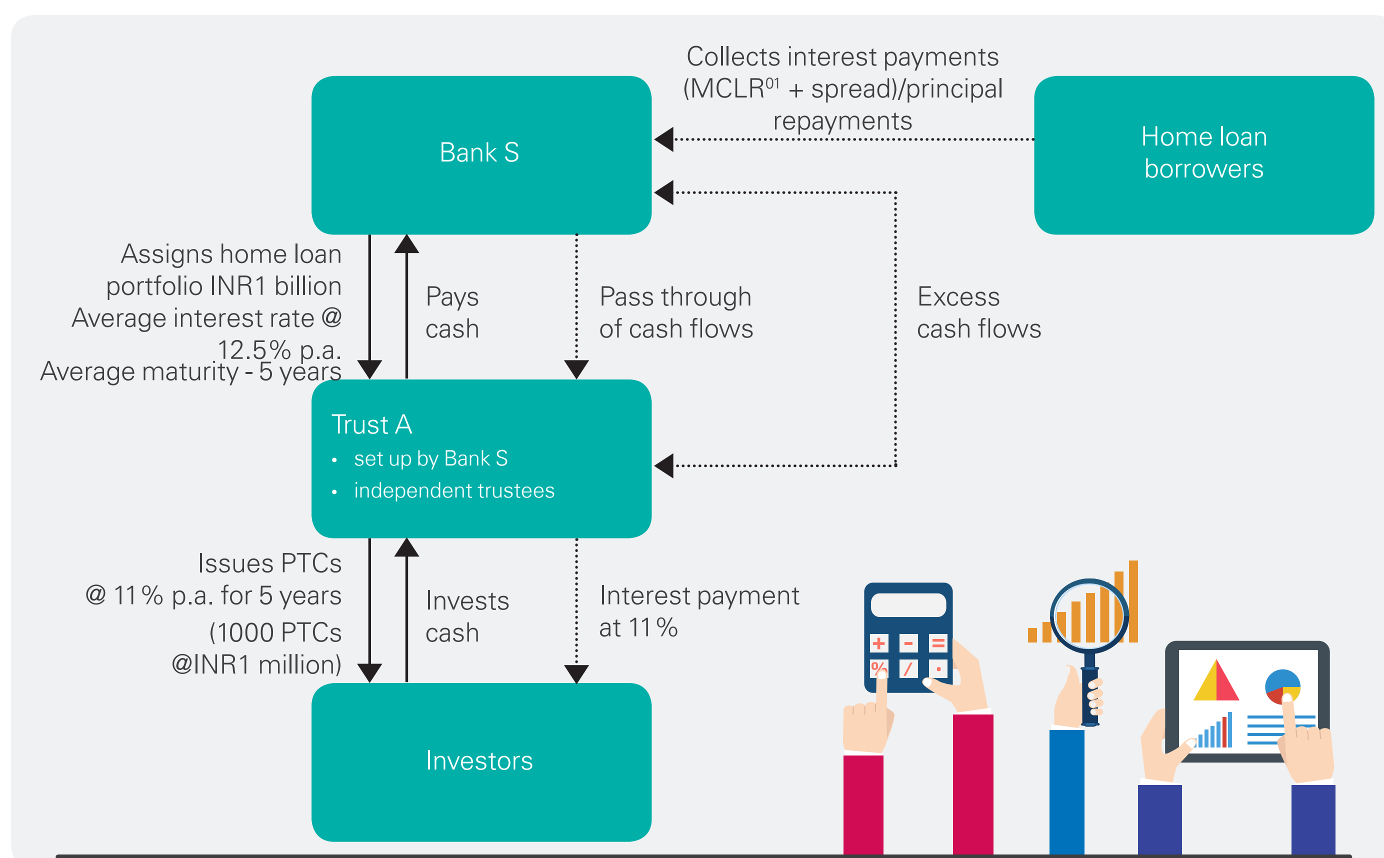
This article highlights the interaction between derecognition and consolidation guidance, as relevant for securitisation transactions, with the help of the following example.

Example: Securitisation of home loans

Figure 1 illustrates the structure for a securitisation transaction involving assignment of a portfolio of home loans by Bank S to an SPV – 'Trust A' on 1 April 2016:



Since the assignment was in the nature of a 'true sale' on 1 April 2016,, the bank derecognised the home loan portfolio from its financial statements (except to the extent, it continued to hold 10 per cent of the loan portfolio in accordance with the RBI guidelines) under previous GAAP. The difference between the income earned on the home loan portfolio and the interest paid to investors, being 'excess returns', would be passed on to Bank S on a subordinated basis. The excess returns serve as a 'first loss' credit enhancement for the external investors. Bank S also provided Trust A with credit enhancement facilities in the form of an off-balance financial guarantee.

Accounting issue

Subsequently, on the date of transition to Ind AS (1 April 2017), Bank S is required to determine how the transition provisions for derecognition of financial instruments (in Ind AS 101, *First- time adoption of Indian Accounting Standards*) would apply to this securitisation transaction in its separate and consolidated financial statements.

Accounting guidance and analysis

Separate financial statements

The bank has provided credit enhancement in terms of a 'first loss' facility as well as a guarantee to the trust. On the basis that these facilities result in continued exposure to the credit risk, interest rate risk, liquidity risk and some prepayment risk associated with the home loans, the bank would be unable to derecognise the loans from its financial statements. However, as per Ind AS 101, the derecognition requirements are applied prospectively to transactions occurring on or after the transition date, i.e. 1 April 2017. Therefore, Bank S would not be permitted to recognise the home loans in its separate financial statements since these loans had already been derecognised (prior to transition date) under previous GAAP based on legal 'true sale' criterion.

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01. Marginal Cost of funds based Lending Rate

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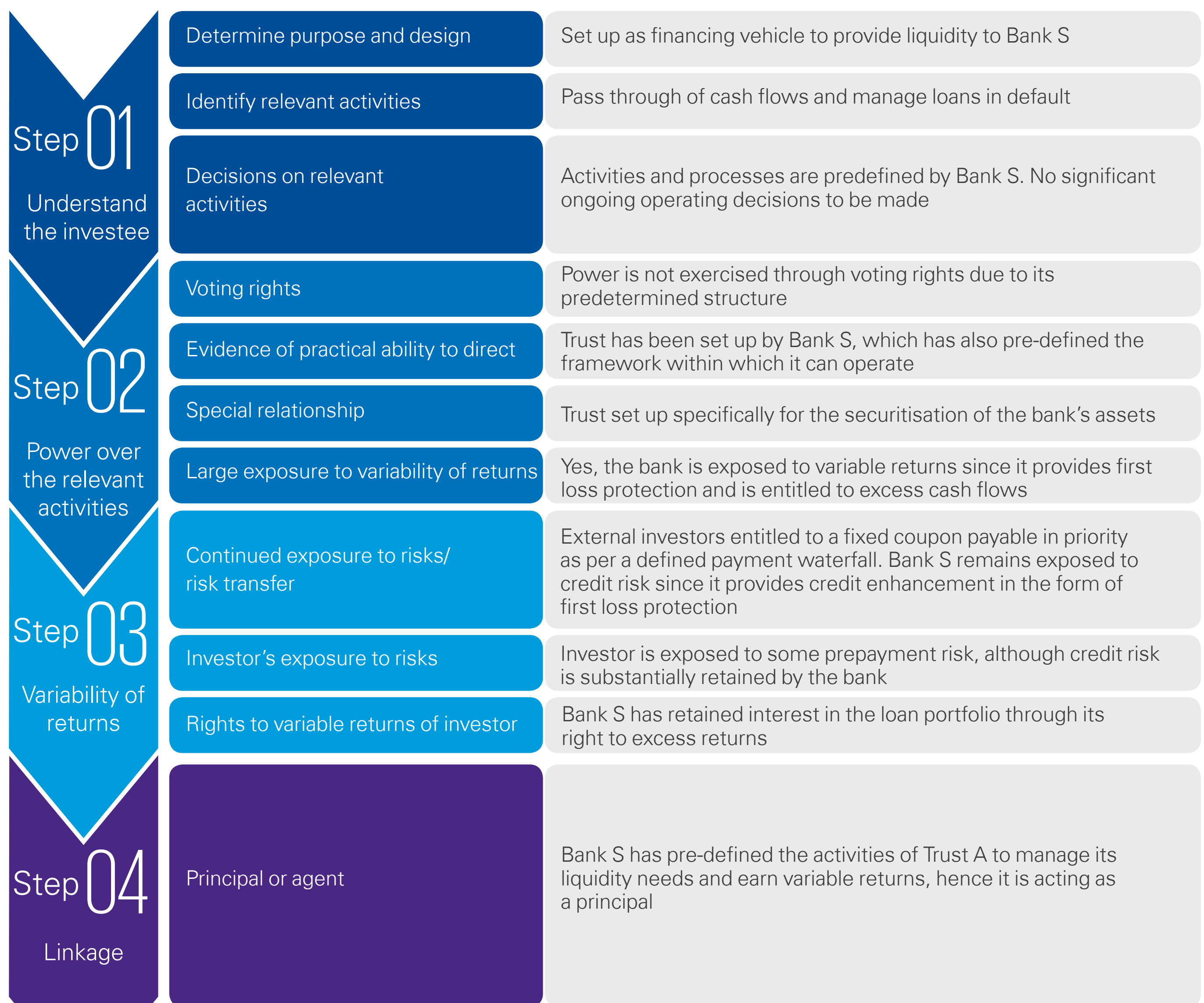
Consolidated financial statements

When determining whether the securitised assets should be derecognised in the consolidated financial statements of Bank S, the first step for the bank is to evaluate whether it should consolidate Trust A on transition to Ind AS. Subsequently, the bank should assess whether the securitised loans meet the derecognition criteria in Ind AS 109 at the consolidated level. Under IGAAP, Bank S was not required to consolidate the financial statements of Trust A since it did not exercise 'control' in accordance with AS 21. However, under Ind AS 110, the evaluation of control is based on a four step model.

Ind AS 101 does not provide for any exemption from the consolidation requirements of Ind AS 110. Therefore, the bank should determine whether it 'controls' Trust A based on the guidance in Figure 2 below.

Figure 2: Control analysis for Bank S



The analysis above indicates that Bank S controls the trust since:

- It has established the trust and the securitisation structure to meet its funding and liquidity requirements as well as to obtain capital relief;
- The activities of the trust are largely pre-determined by the bank and are fairly narrow in scope, requiring no significant operating decisions to be made; and
- It continues to be exposed to substantially all the credit risk as well as interest rate risk. Although some prepayment risk is transferred to the investors, the bank is also exposed to prepayment risk on its right to excess returns.

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Evaluation for derecognition in consolidated financial statements

The derecognition requirements need to be applied to the consolidated financial statements of Bank S, which include the trust. The loans were not derecognised at a consolidated level under previous GAAP since, previously, there was no requirement to consolidate the trust under AS 21. The Ind AS 101 exemption related to past derecognition of financial assets would therefore not apply. The bank would therefore have to evaluate the transaction under Ind AS 109 to determine if it qualifies from derecognition at a consolidated level at the time of transition to Ind AS.

The securitisation transaction does not appear to meet the ‘pass through’ requirements in Ind AS 109 since all collections are not passed on to the external investors (some of the amounts collected are retained by the bank as excess cash flows). Further, the bank appears to retain substantially all risks and rewards through its continued exposure to credit risk and marginal returns. This indicates that the bank would continue to recognise the securitised loans in its consolidated financial statements. The PTCs issued to external investors would be classified as borrowings.

Consider this

- Currently, RBI guidelines require ‘true sale’ criteria to be met to permit securitised assets to be removed from the balance sheet of the originating bank. These criteria differ from the requirements of Ind AS 109 and may result in different outcomes. The RBI’s Report of the Working Group on Ind AS released in September 2015, recommends alignment of the accounting framework for derecognition and securitisation with the principles of Ind AS 109, while retaining prudential tools/filters to manage the impact on regulatory capital requirements, dividend distribution, etc.

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