Securitisation accounting: Disconnects between RBI Guidelines & Indian Accounting Standards

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Background

Non-banking finance companies (NBFCs), based on the roadmap issued the Ministry of Corporate Affairs[1], have moved into Ind ASes effective this year, and banks will be moving into the same from the next year. There are several areas where there are dis-connects between the regulatory prescription and the accounting standards. Some of these may be direct conflict – that is, the regulatory prescription may be inconsistent with the accounting standards. At some places, there may be divergence, though not necessarily amounting to a conflict.

As IFRSs/Ind ASes are implemented progressively, the question will continue to loom large as to what is the right approach. There are 3 possible options:

- IFRSs/Ind ASes being essentially accounting standards, remain relevant for general purpose accounting and reporting. That is, general purpose financial statements are mandatorily required by the Companies Act to be prepared as per applicable accounting standards, and for those entities which have migrated into Ind ASes, the same constitute the mandatorily applicable accounting standards. Hence, the regulatory prescriptions, to the extent the same are in direct conflict with the accounting standards, are ignored.

    - Regulatory prescription overrides accounting standards. Para 9 of Chapter V the Prudential Regulations/Master directions says: "Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India (referred to in these Directions as "ICAI") shall be followed insofar as they are not inconsistent with any of these Directions." This is interpreted to mean that in case of an inconsistency, it is the regulations which prevail.

- The third possible view is that IFRS/Ind ASes will remain relevant for general purpose financial reporting. As regards adherence to RBI directions is concerned, the same may be restricted to compliance with the RBI's prudential directions, and for RBI reporting. In essence, there will be two parallel financial statements – one for general purpose reporting, which will be as per Ind ASes, and one for regulatory accounting, which will be as per RBI guidelines.

This write-up discusses the disconnects, and conflicts. There may be several consequential implications of these, for instance on regulatory capital, etc. We have also discussed how other countries have tackled similar situations of conflict or disconnects.

Experience with IFRS convergence in other countries:

In most of the European jurisdictions, banks and financial entities have moved over to IFRSs. However, the regulatory framework in each country is different, and therefore, it is difficult to find global proxies for the kind of disconnects faced in India. India is a case where there is a detailed regulatory prescription, by

[1] Refer our write up on the issue here - http://vinodkothari.com/wp-content/uploads/2017/02/Applicability_of_Ind-AS_on_NBFCs.pdf

the financial regulator, for matters like non-performance assets (NPAs), impairment (provisions in case of NPAs), accounting treatment for investments, accounting treatment for securitisation, etc.

However, if the global architecture of regulations is based on the Basel regulations, there also, there are disconnects between the regulatory requirements, and IFRSs. Therefore, most of the global discussion has centred around the Basel regulations and IFRSs.

One of the major issues globally has been the treatment of Expected Credit Losses (ECL) for regulatory purposes. As may be well-known, ECL computation involves credit assets of different shades, including those assets where there has been no deterioration in credit quality. Therefore, the issue has been whether ECL, or a part of it, can be regarded as a "general loss provision" which forms part of Tier 2 Capital under Basel II/ Basel III.

The matter was discussed in a BCBS discussion paper[2]. US regulators have also proposed amendment in capital requirements for inclusion of "allowance for credit losses" as a part of Tier 2 capital[3].

Issues in India under Ind AS that do not synchronise with the RBI Directions

In India, the whole range of issues pertaining to implementation of accounting standards for financial instruments and the disconnects, if any, with regulatory standards, has already been discussed by the Working Group on Implementation of Ind AS in India[4]. In this write-up, we are confining ourselves with the issues pertaining to securitisation accounting.

Sl No.	Issue	Under relevant Ind AS	Under RBI Guidelines	Our comments
1.	De-recognition of financial assets in case of securitisation	The de-recognition principles have been laid down in Ind AS 109. As per para 3.2.6 of Ind AS 109, de-recognition of financial assets can be achieved only upon fulfilment of the conditions laid down therein. To summarise the conditions contained therein, there can be three situations:	Under the RBI Directions, in order to achieve, a financial institution can derecognise the assets only upon satisfaction of "true sale" criteria for the assets. The Directions, however, allow retention of beneficial interest in the assets, even after its sale.	In the securitisation structures prevalent in India, the originators retain the entire excess spread. The originators also retained the subordinated class of PTCs issued by the securitisation trust, in order to comply with the MRR as also to provided the needed enhancement.

[2] https://www.bis.org/bcbs/publ/d385.pdf. See also : https://www.bis.org/fsi/fsisummaries/ifrs9.pdf
[3] https://www.fdic.gov/regulations/capital/presentation-2018-05-15.pdf
[4] https://rbidocs.rbi.org.in/rdocs/Content/PDFs/FAS93F78EF58DB84295B9E11E21A91500B8.PDF

		a. Transfer of all risks and returns – assets to be de-recognised from the books b. Retention of all risks and returns – assets not be derecognised c. Retention of some risks and returns – however, surrender of control – partial de-recognition of financial assets	There are separate guidelines for minimum risk retention (MRR) – these require a minimum risk retention in case of a securitisation transaction. The MRR requirements also say that if there is an equity tranche, equal to the MRR, the entire equity tranche will have to be retained by the originator. Thus, retention of first loss risk is a mandatory requirement under the RBI guidelines. Also the RBI guidelines state that the retention of the excess spread by the originator does not breach the true sale requirements.	As there are usually only two classes – a AAA/AA class and an originator-retained unrated class, it transpires that virtually the entire credit risk is retained by the originator. Retention of the excess spread implies that the entire rewards also flow back to the originator. Considering the above, the structures would lead to retention of risks and rewards in the hands of the originator. Therefore, though the transaction may qualify for a legal de-recognition after fulfilling the true sale criteria, however, the same may not fulfil the accounting principles for de-recognition. Thus, there is a clear conflict between accounting de-recognition, and regulatory de-recognition. For accounting de-recognition, the situation is almost clear – transaction structures as they currently prevail will not qualify for off-balance sheet treatment. Can it, therefore, be argued that even though the asset has stayed on the balance sheet of the originator, the assets which qualify for regulatory

				de-recognition conditions will still be eligible for capital relief? This seems to be the clear position in most of the European jurisdictions, where off-balance sheet securitisation is uncommon; however, the capital relief requirements relate to the retained risk in form of ratings of the various tranches.
2.	De-recognition in case of direct assignments	Ind-AS does not make a distinction between securitisation and direct assignment – hence, the requirements for de-recognition remain the same.	The RBI guidelines in case of direct assignment prohibit any credit enhancement. Thus, while there is an MRR to the extent of at least 10%, however, that is by way of a vertical tranche of the pool, that is, a pari passu share in the receivables.	Market practices in case of direct assignment are that the share of principal and the share of interest retained by the originator is not the same – the share of principal is equal to the MRR, but the share of interest is higher, thus effectively giving lower interest to the investor. Evidently, direct assignment is a case where qualifying for de-recognition for Ind ASes will be easiest – since, to the extent of the fully proportional share of principal and interest sold, there is no risk/reward retention by the originator.
3.	Profit or loss at the time of transfer of asset	As per para 3.2.12 of the Ind AS 109, if there is any difference in the carrying amount of assets at time of de-recognition and the consideration, the difference must be recognised in the profit and lost.	As per the provisions of para 1.5 of the securitisation guidelines, if there is any profit/ premium on transfer of assets, the same must be amortised over the tenure of the transaction as per the function provided therein.	First of all, it is important to understand that the question of booking of gain or loss on sale will arise only where the asset in question qualifies for de-recognition. If there is no de-recognition, there is no question of any gain or loss on sale.

		The consideration received from transfer includes the element of retained interests in the assets, for instance, the value of the retained excess spread or reversionary interest.		In case of direct assignments, where de-recognition is almost certain, there is a clear conflict between the RBI guidelines and the accounting standards. Irrespective of whether the sale of the pool happens to be at more than the par value (premium structure) or not (par structure), the value of the future expected excess spread will still be priced, and the fair value of the same will be taken as a retained interest, which is to be brought on books. Thus, there will be a gain-on-sale booking for most direct assignments.
4.	Consideration of ECL for capital adequacy requirements	The Ind AS 109 introduces the concept of expected credit loss method of provisioning, which is significantly different from the existing model of incurred credit loss method of provisioning. This could lead to a situation where the opening retained earnings of the financial institutions could be eaten up due to the increased provisioning, thereby affecting the capital of the financial institution. Currently, RBI allows financial institutions to consider general loss provisions as a part of the Tier 2 capital. We have mentioned above that there is currently international discussion on inclusion of ECL for the part of Tier 2 capital. Regulations distinguish between banks under the Standardised approach of capital computation, and those under IRB.		The RBI's Working Group on Implementation of IndAS by banks[5] suggested that – "*the RBI may need to consider this aspect and the possibility of a regulatory forbearance for capital adequacy purposes while transitioning to Ind AS*". Further, the Basel Committee on Banking Supervision[6] also sought comments on the following three approaches to allow banks to adjust to the new ECL accounting standards:

[5] https://rbi.org.in/Scripts/bs_viewcontent.aspx?Id=3093#8
[6] https://www.bis.org/publ/qtrpdf/r_qt1703x.htm

				a. Approach 1: Day 1 impact on Common Equity Tier 1 (CET1) capital spread over a specified number of years; b. Approach 2: CET1 capital adjustment linked to Day 1 proportionate increase in provisions; or c. Approach 3: Phased prudential recognition of IFRS 9 Stage 1 and 2 provisions. Further, the BCBS also prefers the first model as the same tackles capital shock in a straight forward manner. However, nothing conclusive has been issued by any of the regulators as of yet which is creating confusion among the various stakeholders.
5.	Fair valuation of financial instruments	As per Ind AS 109, fair valuation of financial instruments have to be done in accordance with Ind AS 113. Further, the difference in the fair value has to be adjusted in the books of accounts depending on the method adopted for recognition of financial assets, i.e., Amortised Cost Method, Fair Value through Other Comprehensive Income Method or	As per the RBI Directions, the term fair value has been defined as the "*mean of the earning value and the break up value*", unless otherwise provided anywhere in the Directions. Further, all this while there was no requirement of fair valuation of loans and advances for the purpose of recognising the same in the books.	There is a de-sync between the provisions of the RBI Directions and the Ind AS in this regard. Further, it is also unclear whether for the purpose of capital adequacy requirements, risk weights have to be applied on the fair value of the assets as per the RBI Directions or as per the Ind AS.

		Fair Value through Profit or Loss Method.		
6.	Recognition of income on non-performing assets	Under Ind AS 109, interest from any financial asset has to be recognised based on the effective interest rate after applying the same on the gross carrying amount or net carrying amount of financial assets depending on the stage in which the loan is.	As per the RBI Directions, interest income on non-performing assets (NPAs) have to be recognized on cash basis only.	There is a difference in the income recognition principle for non-performing assets. The ECL methodology lays down that if the credit asset in question was already impaired, in that case the estimate of lifetime losses will be done, and the effective interest rate will be computed only on the impaired value. Therefore, while AS requires lifetime ECL computation, it still permits income recognition.
7.	Sale of NPAs – recognition of loss/ gain	As per para 3.2.12 of the Ind AS 109, if there is any difference in the carrying amount of assets at time of de-recognition and the consideration, the difference must be recognised in the profit and loss.	The RBI Directions on sale of NPA provide for the following: a. deferment of recognition of gains/ losses, where the NPAs are sold to ARCs; b. Adjustment of gains with the shortfall/ loss on account of sale of other NPAs, in other cases.	This is a case of a disconnect

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