Handbook on Securitisation, Asset Reconstruction and Enforcement of Securities Interest

INDEX

(1) SECURITISATION

What is securitisation?

Securitisation is the process of conversion of existing assets (impaired or otherwise) or future cash flows into marketable securities. In other words, securitisation deals with the conversion of assets which are not marketable into marketable ones.

According to Investopedia, “Securitization is the process of taking an illiquid asset, or group of assets and through financial engineering, transforming them into a security”.

Types of securitisation:

Generally, there are two kinds of securitisation transactions depending on what is being securitised. They are

1. **Asset based securitisation**- In this case the assets of the entity are transferred by the originator to the end investor. Sometimes, these assets may be impaired or incompetent to generate revenues or income.
2. **Future-flows securitisation**- In this case, future cash flows or receivables are transferred to the investor which again may carry the risk of being realised in full or only in part and sometimes, it needs to be written off as bad debts.

What can be securitised?

Any asset that generates income or stream of cash flows can be securitised. Typically, there are four classes of financial assets that can be securitised. They are:

1. Loans like
    a) Auto Loans
    b) Personal Loans
    c) Home Loans
    d) Student Loans and
    e) Consumer Durable Loans
    f) Equipment Loans/Lease

2. Receivables like
    a) Credit Sales of goods or services
    b) Ticket Sales
    c) Credit card payments
    d) Toll Receipts

3. Risk Transfers like
    a) Weather risk
    b) Insurance risk
    c) Credit risk

4. Asset based securities like
    a) Residential mortgage backed securities
    b) Commercial mortgage backed securities

However, Residential mortgage backed securities (RMBS) and Commercial mortgage backed securities (CMBS) form the major asset class that are securitised in the securitisation world.

(2) GLOBAL WALK OF SECURITIZATION

Examples of securitization can be found at least as far back as the 18th century. Among the early examples of mortgage-backed securities in the United States were the farm railroad mortgage bonds of the mid-19th century, which contributed to the panic of 1857. Asset securitization began with the structured financing of mortgage pools in the 1970s. In February 1970, the U.S. Department of Housing and Urban Development created the transaction using a mortgage-backed security. The Government National Mortgage Association sold securities backed by a portfolio of mortgage loans. Securitization only reached Europe in late 80's, when the first securitizations of mortgages appeared in the UK.

To facilitate the securitization of non-mortgage assets, businesses substituted private credit enhancements. First, they over-collateralized pools of assets; shortly thereafter, they improved third-party and structural enhancements. In 1985, securitization techniques that had been developed in the mortgage market were applied for the first time to a class of non-mortgage assets—automobile loans. As a pool of assets second only to mortgages in volume, auto loans were a good match for structured finance; their maturities, considerably shorter than those of mortgages, made the timing of cash flows more predictable, and their long statistical histories of performance gave investors confidence.

This early auto loan deal was a $60 million securitization originated by Marine Midland Bank and securitized in 1985 by the Certificate for Automobile Receivables Trust (CARS, 1985-1). This technology only really took off in the late 90's or early 2000, thanks to the innovative structures implemented across the asset classes. Securitization as a financial instrument has been in practice in India since the early 1990s essentially as a device of bilateral acquisitions of portfolios of finance companies.

(3) INDIAN SCENARIO

Securitization in its present form originated in mortgaged markets of USA in 1970. Government promoted the secondary markets in mortgaged to promote liquidity for mortgage in finance companies. In India, first securitization deal dates back to 1990 when Citibank secured auto loans & sold to the GIC Mutual Fund. Securitization markets began to grow post globalization & integration of capital markets in India when financial players in India adopted innovative strategies to promote liquidity in the then illiquid mortgage markets.

Through most of the 90s, securitization of auto loans was the mainstay of the Indian markets. But since 2000, Residential Mortgage Backed Securities (RMBS) have fuelled the growth of the market.

The need for securitization in India exists in three major areas –

1. Mortgage Backed Securities (MBS),
2. The infrastructure Sector and
3. Other Asset Backed Securities (ABS).

It has been observed that Financial Institutions and Banks have made considerable progress in financing of projects in the housing and infrastructure sector. It is therefore necessary that securitization and other allied systems get developed so that Financial Institutions and Banks can offload their initial exposure and make room for financing new projects. With the introduction of financial sector reforms in the early nineties, Financial Institutions and Banks, particularly the Non-Banking Financial Companies (NBFCs), have entered into the retail business in a big way, generating large volumes of homogeneous classes of assets such as auto loans, credit cards receivables, home loans. This has led to attempts being made by a few players to get into the Asset Backed Securities market as well. However, still a number of legal, regulatory, psychological and other issues need to be sorted out to facilitate the growth of securitization. People of India have not yet welcomed this concept.

First legal framework for securitization in India was not drafted until 2002 when Securitization and Reconstruction of Financial Assets & Enforcement of Security Interest Act was promulgated. By the late 1990s, rising level of Bank NPAs raised concerns and Committees like the Narasimham Committee II and Andhyarujina Committee which were constituted for examining Banking sector reforms considered the need for changes in the legal system to address the issue of NPAs. These committees suggested a new legislation for securitization, and empowering Banks and FIs to take possession of the securities and sell them without the intervention of the court and without allowing borrowers to take shelter under provisions of SICA/BIFR. Acting on these suggestions, the SARFAESI Act was passed in 2002 to legalize securitization and reconstruction of financial assets and enforcement of security interest. The act envisaged the formation of asset reconstruction companies (ARCs)/ Securitization Companies (SCs).

(4) WHY IS SECURITISATION NEEDED?

A finance enterprise always needs funds or finance to run, survive and maintain and grow its business. Many a times, a company may have a very strong balance sheet showing good amount of assets but still may not have adequate cash to pay its bills, creditors, employees or meet emergency situations. The reason may be because some of these assets may be impaired or incompetent to generate revenues or cash. In such a case, sometimes, a company does not want to look for traditional or external sources of finance. Then one of the options that the company has is to securitise its assets or receivables.

A finance company has several funding sources available to obtain the necessary capital to run its business. These sources include deposits, bank loans, issuing corporate stock or unsecured bonds and, finally, asset-backed securities (securitizations). The securitization option allows a finance enterprise to raise large amounts of capital at costs that allows them to maximize “net interest margin” for the life of the loans.

Securitization is one way in which a company might go about financing its assets. There are generally the following reasons why companies consider securitization:

1. Improved capital returns:

   To improve their return on capital, since securitization normally requires less capital to support it than traditional on-balance sheet funding;

2. Raise finance:

   To raise finance when other forms of finance are unavailable (in a recession Banks are often unwilling to lend - and during a boom, Banks often cannot keep up with the demand for funds);

3. Better return on assets:

   Securitization can be a cheap source of funds, but the attractiveness of securitization for this reason depends primarily on the costs associated with alternative funding sources;

4. Diversify portfolio:

   To diversify the sources of funding which can be accessed, so that dependence upon Banking or retail sources of funds is reduced;

5. To lower risk:

   To reduce credit exposure to particular assets for instance, if a particular class of lending becomes large in relation to the balance sheet as a whole, then securitization can remove some of the assets from the balance sheet;

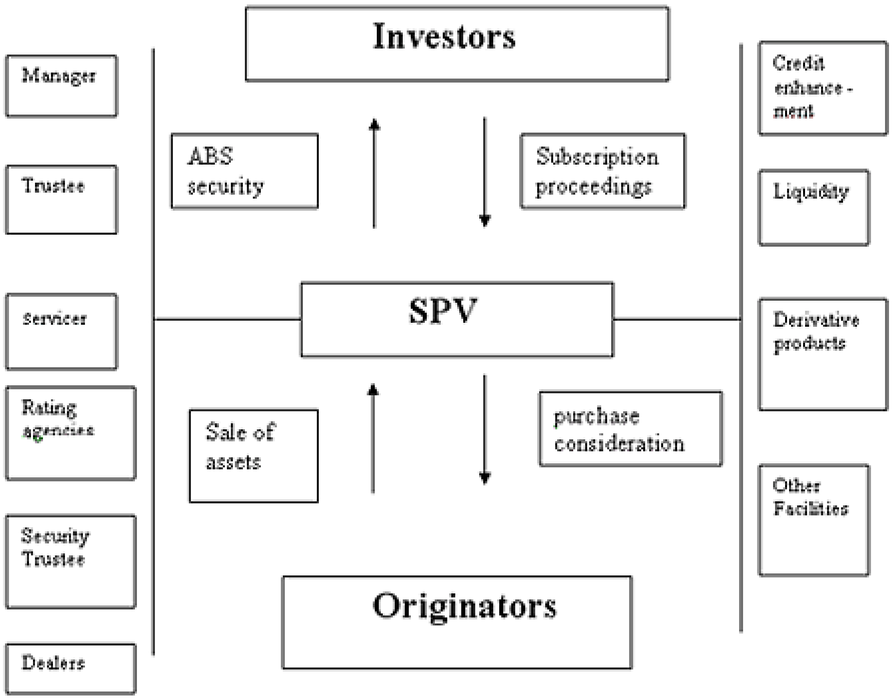
6. Manage mortgage assets:

   To match-fund certain classes of asset - mortgage assets are technically 25 year assets, a proportion of which should be funded with long term finance; securitization normally offers the ability to raise finance with a longer maturity than is available in other funding markets;

7. Benefits:

To achieve a regulatory advantage, since securitization normally removes certain risks which can cause regulators some concern, there can be a beneficial result in terms of the availability of certain forms of finance (for example, in the UK building societies consider securitization as a means of managing the restriction on their wholesale funding abilities).

Simplistic Graphical Ramification



(5) HOW DOES IT WORK?

Now let's understand the process of securitisation with the example of a bank called Ideal Bank:

1. Loans are given out by the Bank. The loans given out by this bank are its assets. Thus, the bank has a pool of these assets on its balance sheet and so the funds of the bank are locked up in these loans. The bank gives loans to its customers. The customers who have taken a loan from the Ideal Bank are known as obligors.

2. Then these loans for example let us say auto loans issued over a period of time are packaged together. The bundled loans are transferred to a bankruptcy-remote Special Purpose Entity (SPE), which in turn transfers the bundles loans to a bankruptcy-remote Asset-Backed Securities (ABS) trust. The SPV is a separate entity formed exclusively for the facilitation of the securitisation process and providing funds to the originator. The assets being transferred to the SPV need to be homogenous in terms of the underlying asset, maturity and risk profile.

What this means is that only one type of asset (eg: student loans) of similar maturity (eg: 30 to 36 months) will be bundled together for creating the securitised instrument. The SPV will act as an intermediary which divides the assets of the originator into marketable securities.

These securities issued by the SPV to the investors and are known as pass-through-certificates (PTCs) or beneficial interest certificates. The cash flows (which will include principal repayment, interest and prepayments received) received from the obligors are passed onto the investors (investors who have invested in the PTCs) on a pro rata basis once the service fees has been deducted.

The difference between rate of interest payable by the obligor and return promised to the investor investing in PTCs is the servicing fee for the SPV.

The way the PTCs are structured the cash flows are unpredictable as there will always be a certain percentage of obligors who won't pay up and this cannot be known in advance. Though various steps are taken to take care of this, some amount of risk still remains.

3. The ABS trust becomes the permanent home for the loans.

4. The ABS trust uses the loans as collateral for corporate bonds that are sold to investors. The trust uses the proceeds from the sale of the bonds to pay the company for the loans that were transferred to the trust. Bonds backed by the expected payments on a pool of assets (such as auto loans or student loans) are known as asset-backed securities. The transaction itself is referred to as a securitization.

How do the investors get paid?

a. Each month, Ideal Bank's customers make payments on their auto loans. Ideal Bank receives a fixed amount of money: 1) loan principal and 2) the interest portion of the customer's payment. These monthly payments are submitted directly to the ABS trust.

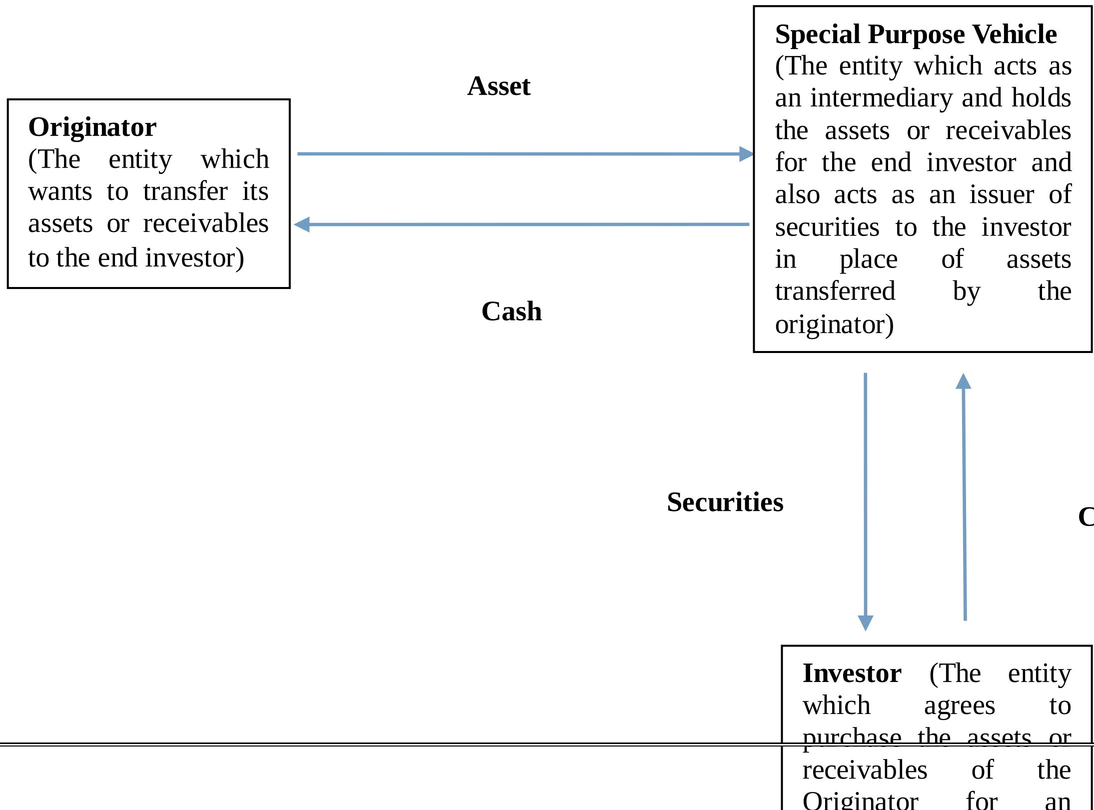
b. The ABS trust uses this monthly cash flow from Ideal Bank's customers to repay the bond investors. The investors receive a monthly payment: 1) principal (to repay the borrowed money) and 2) interest, or coupon, which is the interest rate paid on the bonds.

c. Ideal Bank earns (or receives) the net interest margin – which is the difference between the interest rate that our customers pay on their auto loans and the interest rate paid to the investors. For example, the securitization named Auto Loan-2013 has an average customer interest rate of 14.9 percent, but we are only required to pay the investors approximately 4.5 percent. Therefore, GM Financial will earn a 10.4 percent net interest margin (14.9 percent minus 4.5 percent) on these loans before covering credit losses, operating expenses and any fees associated with the securitization.

Utilizing a securitization locks in the net interest margin for the company for the entire life of the securitization, removing exposure to changes in interest rates for these specific loans.

As net interest margin is generated, cash is available to the company to cover operating costs, credit losses and taxes. Anything left over is Ideal Bank's profit. This can be reinvested in new loans. Then, we start the cycle again – originating new loans, funding our dealers and transferring loans to warehouse lines or securitization trusts. at all times is made possible through a process called securitization. The map on this page illustrates that process. From originations, to selling securities to bond investors, to cash flow from our customers' payments, it's a continuous cycle that keeps Ideal Bank's business going day after day.

The following diagram depicts the process of securitisation:



Who are the participants?

There are mainly three parties involved in the process of securitisation. They are:

1. **Originato**r - This is the entity which wants to remove or unblock some assets or receivables from its balance sheet. Some of these assets or receivables may be impaired or incompetent generate cash or incomes.
2. **Special Purpose Vehicle or the Issuer-** This is the intermediary who holds the assets transferred by the Originator on behalf of the end investor and it is the function of this entity to issue marketable securities to the investor in place of the assets taken up by it.
3. **Trust or Trustee -** Sometimes, the SPV creates another entity or trustee to manage the transactions by transferring the bundles loans to the trustee. However, sometimes, the SPV only handles everything without any trustee in the scene.
4. **Investor -** It is this entity which wants to purchase the assets or receivables of the Originator. The investor makes his profit by receiving fixed or floating payments from the SPV or the trustee created in the process.

Who can be an Originator?

A large number of financial institutions employ securitization to transfer the credit risk of the assets they originate from their balance sheets to those of other financial institutions, such as banks, insurance companies, and hedge funds.

Section 5 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 orders that only banks and financial institutions can securitise their financial assets.

Who can be the investors?

The investors can be banks, mutual funds, other financial institutions, government etc. In India

The investors can be banks, mutual funds, other financial institutions, government etc. In India only qualified institutional buyers (QIBs) who possess the expertise and the financial muscle to invest in securities market are allowed to invest in PTCs.

Mutual funds, financial institutions (FIs), scheduled commercial banks, insurance companies, provident funds, pension funds, state industrial development corporations, et cetera fall under the definition of being a QIB. The reason for the same being that since PTCs are new to the Indian market only informed big players are capable of taking on the risk that comes with this type of investment.

Role of rating agencies in the process of securitisation:

In order to facilitate a wide distribution of securitised instruments, evaluation of their quality is of utmost importance. This is carried on by rating the securitised instrument which will acquaint the investor with the degree of risk involved.

The rating agency rates the securitised instruments on the basis of asset quality, and not on the basis of rating of the originator. So particular transaction of securitisation can enjoy a credit rating which is much better than that of the originator.

High rated securitised instruments can offer low risk and higher yields to investors. The low risk of securitised instruments is attributable to their backing by financial assets and some credit enhancement measures like insurance/underwriting, guarantee, etc used by the originator.

The administrator or the servicer is appointed to collect the payments from the obligors. The servicer follows up with the defaulters and uses legal remedies against them. In the case of Ideal bank, the SPV can have a servicer to collect the loan repayment instalments from the people who have taken loan from the bank. Normally the originator carries out this activity.

Once assets are securitised, these assets are removed from the bank's books and the money generated through securitisation can be used for other profitable uses, like for giving new loans.

For an originator (Ideal bank in the example), securitisation is an alternative to corporate debt or equity for meeting its funding requirements. As the securitised instruments can have a better credit rating than the company, the originator can get funds from new investors and additional funds from existing investors at a lower cost than debt.

Benefits and disadvantages of securitisation

The Securitization structure is intended to provide significant advantages such as:

1. When the receivables are moved "off balance sheet" and replaced by a cash equivalent (less expenses of the Securitization), it improves the Originator's balance sheet.

2. Securitisation can improve and enhance managerial control over the size and structure of a firm's balance sheet. When you are de-recognising some of the assets (i.e., removal from the balance sheet), it can improve gearing ratios as well as other units of measuring economic performance (e.g., Return on Equity). Financial institutions use securitisation to achieve capital adequacy targets, particularly where assets have become impaired.

3. It also reduces a firm's weighted-average cost of capital. This becomes possible because sometimes, equity capital is no longer required to support the assets. In addition to this, highly rated debt can be issued into deep capital markets with investor demand driving down financing costs.

4. Securitisation also releases capital for other investment opportunities. When external borrowing sources are constrained, they generate economic gains or even if there are differences between internal and external financing costs.

5. The originator does not have to wait until it receives payment of the receivables (or, in a "future flow" securitization, until it even generates them) to obtain funds to continue its business and generate new receivables. In many cases this is essential and a role otherwise filled by more traditional methods of financing, including factoring (in some ways securitization is a very sophisticated form of factoring). This is more significant when the receivables are relatively long term, such as with real property mortgages, auto loans, student loans, etc. and not as significant with short term receivables, such as trade and credit card receivables.

6. The securities issued in the securitization are more highly rated by participating rating agencies (because of the isolation of the receivables in a "bankruptcy-remote" entity), thus reducing the cost of funds to the originator when compare to traditional forms of financing. In instances where the receivables bear interest, there is usually a significant spread between the interest paid on the securities and the interest earned on the receivables. Ultimately, the originator receives the benefit of the spread. In addition, the originator usually acts as servicer and receives a fee for its services.

7. Securitisation enables better risk management. It often reduces funding risk by diversifying funding sources. Financial institutions also use securitisation to eliminate interest rate mismatches. For example, banks can offer long-term fixed rate financing without significant risk by passing the interest rate and other market risk to investors seeking long-term fixed rate assets. Securitisation has also been used successfully to give effect to sales of impaired assets. Securitisation also benefits investors. It enables them to make their investment decisions independently of the credit-standing of the originator, and instead to focus on the degree of protection provided by the structure of the SPV and the capacity of securitised assets to meet the promised principal and interest payments. Securitisation also creates more complete markets by introducing new categories of financial assets that suit investors risk preferences and by increasing the potential for investors to achieve diversification benefits. By meeting the needs of different 'market segments', securitisation transactions can generate gains for both originators and investors.

8. In non-revolving or non-floating structures, and those with fixed interest rate receivables, assets and related liabilities can be matched, eliminating the need for hedges.

9. Because the originator usually acts as servicer and there is normally no need to give notice to the obligors under the receivables, the transaction is transparent to the originator's customers and other persons with whom it does business.

Disadvantages of securitisation:

However, like every financial structure, a securitization structure also can have his disadvantages, such as:

1. The task of synchronising the interest generated by the bundled asset pool or receivables pool and the interest paid to the investors is a very difficult and long process.

2. Apart from this, the transfer of mortgages may be difficult for legal, regulatory or tax reasons. In most countries, such transactions have to satisfy the requirements of regulatory authorities. In India, such transfers have to fulfill the conditions and guidelines laid out by the Securitisation Act, 2002 and also the guidelines of the RBI.

3. As the securitisation activity involves a large number of investors and a large number of assets or receivables, the complexity of the transaction is very high and it requires a very highly sophisticated documentation and such documentation should cover every possible risk. The higher the complexity of a transaction, the higher the cost of documentation.

Impact on banking

Other than freeing up the blocked assets of banks, securitisation can transform banking in other ways as well.

The growth in credit off take of banks has been the second highest in the last 60 years. But at the same time the incremental credit deposit ratio for the past one-year has been greater than one. In simple words, this means, for every Rs 100 worth of deposit coming into the system more than Rs 100 is being disbursed as credit. The growth of credit off take though has not been matched with a growth in deposits. So the question that arises is, with the deposit inflow being less than the credit outflow, how are the banks funding this increased credit offtake?

Banks essentially have been selling their investments in government securities. By selling their investments and giving out that money as loans, the banks have been able to cater to the credit boom. This form of funding credit growth cannot continue forever, primarily because banks have to maintain an investment to the tune of 25 per cent of the net bank deposits in statutory liquidity ratio (SLR) instruments (government and semi government securities).

The fact that they have been selling government paper to fund credit off take means that their investment in government paper has been declining. Once the banks reach this level of 25 per cent, they cannot sell any more government securities to generate liquidity. And given the pace of credit off take, some banks could reach this level very fast. So banks, in order to keep giving credit, need to ensure that more deposits keep coming in. One way is obviously to increase interest rates. Another way is Securitisation. Banks can securitise the loans they have given out and use the money brought in by this to give out more credit. The bankers in India are of the opinion that a bank might securitise some of its loans to generate funds to keep supporting the high credit off take instead of raising interest rates.

Not only this, securitisation also helps banks to sell off their bad loans (NPAs or non performing assets) to asset reconstruction companies (ARCs). ARCs, which are typically publicly/government owned, act as debt aggregators and are engaged in acquiring bad loans from the banks at a discounted price, thereby helping banks to focus on core activities. On acquiring bad loans ARCs restructure them and sell them to other investors as PTCs, thereby freeing the banking system to focus on normal banking activities.

Asset Reconstruction Company of India Limited (ARCIL) was the first (till date remains the only ARC) to commence business in India. ICICI Bank, Karur Vysya Bank, Karnataka Bank, Citicorp (I) Finance, SBI, IDBI, PNB, HDFC, HDFC Bank and some other banks have shareholding in ARCIL. A lot of banks have been selling off their NPAs to ARCIL. ICICI bank- the second largest bank in India, has been the largest seller of bad loans to ARCIL in the last few years. SBI and IDBI hold second and third positions.

ARCIL is keen to see cash flush foreign funds enter the distressed debt markets to help deepen it. What is happening right now is that banks and FIs have been selling their NPAs to ARCIL and the same banks and FIs are picking up the PTCs being issued by ARCIL and thus helping ARCIL to finance the purchase. So the risk from the balance sheet of banks and FIs is not being completely removed as their investments into PTCs issued by ARCIL will generate returns if and only if ARCIL is able to affect recovery from defaulters.

Thus, banks will have two options- either to raise more capital or to free capital tied up in NPAs and other loans through securitisation.

What are the differences between factoring and securitisation of receivables?

The process of Securitisation involves unlocking of illiquid assets. For example, the receivables of a mortgage finance company are usually locked for long durations and the duration depends on the period over which EMIs are payable by borrowers. These receivables are sold to an SPV (special purpose vehicle) at a discount which in turn issues bonds on the security of the receivables. Therefore the risk lies with the bond holders who are attracted by the high rate of interests carried by such bonds backed by the mortgage loans. Whereas, Factoring, on the other hand, is outsourcing of receivables to the factoring company. Factoring can be done in two ways: either with recourse or without recourse and when it is done without recourse, the risk of bad debts is borne by the factoring agency, which in fact appears to resemble securitisation. However, there is a major difference, in a securitisation transaction; the SPV pays off the mortgage finance company with the proceeds of the bonds issue. Whereas in the case of a factoring agency, the agency does not resort to issue of bonds subsequently but what it does is it pays a portion of the receivables in advance with the remaining being paid at regular intervals as and when debts are collected.

Both the transactions of factoring and securitization involve capitalizing the receivables of the company, however there are many differences between factoring and securitization. Let's understand them briefly:

1. While factoring is agreement between the banks and a company in which financial institution purchases the book debts of a company and pays the money to the company against receivables whereas Securitization is the process of converting illiquid assets into liquid assets by converting longer duration cash flows into shorter duration cash flows.

2. Under factoring there are only two parties involved; the bank and the company whereas in the case of securitization, there are many investors involved who invest in the securitized asset.

3. While factoring is done for short term account receivables ranging from 1 month to 6 months whereas securitization is done for long term receivables of the company.

4. There can be many variations of factoring and can be with or without recourse whereas securitization is done without recourse.

5. In a factoring transaction, only bank and the company are involved and hence there is no need for any credit rating while securitization involves many investors and therefore it is necessary to take credit rating before going for securitization of receivables.

(6) LEGAL FRAMEWORK

The generic law of enforcement is scattered over several Indian statutes such as the Transfer of Property Act, Contract Act, Companies Act and the Civil Procedure Code. Special provisions exist for the benefit of banks and financial institutions including securitization and asset reconstruction companies under the SARFAESI Act. Section 3 of the Act allows securitization/reconstruction companies to be established with the permission of the Reserve Bank of India.

The SARFAESI Act states as its object the regulation of the securitization and reconstruction of financial assets and the enforcement of security interest and matters connected. The essence of the Act is that a secured creditor may, in accordance with the provisions of the Act, enforce any security interest created in his favour without the intervention of a court or tribunal.

The *vires* of the Act was unsuccessfully challenged before the Supreme Court of India in *Mardia Chemicals Ltd v Union of India and Others* in 2004. Banks are now free to attach the properties and sell them without the court's intervention for recovery of their claims.

Under section 2(zd) of the Act, the term 'secured creditor' means any bank or financial institution, or any consortium or group of banks or financial institutions and includes:

(a) A debenture trustee appointed by any bank or financial institution;

(b) A registered securitization company or reconstruction company; or

(c) Any other trustee holding securities on behalf of a bank or financial institution.

A 'bank' is defined (under s2 (c)) to include a banking company, which means any company which transacts banking business in India and includes a foreign company incorporated outside India, which has an established place of business within India. It is compulsory for such companies to register their constituent documents with the Registrar of Companies and submit particulars of their directors, registered office and principal place of business in India.

As such, a foreign company carrying on banking activities (not by way of a mere liaison office) in India should fall within the definition of 'secured creditor' under the Act and will thus be entitled to:

(a) Take possession of the secured assets with the right to transfer them by way of lease, assignment or sale;

(b) Take over the management of the borrower's secured assets with the right to transfer them by way of lease, assignment or sale;

(c) Appoint any person as manager to manage the secured assets which it has taken possession of; and

(d) Require at any time by notice in writing any person who has acquired any of the secured assets from the borrower, to pay to the creditor, so much of the money as is sufficient to pay the secured debt.

The SARFAESI Act is supplemented by the Security Interest (Enforcement) Rules 2002. Draft Guidelines on Securitization of Standard Assets were issued by the Reserve Bank of India on 4 April 2005. These draft guidelines were open for feedback from all concerned for a period of three weeks from that date. They seek to streamline the securitization process by clarifying issues such as when a transaction is to be treated as securitization, etc.

The draft guidelines have four attachments: Attachment 1 prescribes the criteria for a true sale of assets by the originator while attachment 2 prescribes criteria for an SPV under the Securitization Guidelines. Attachment 3 deals with norms for capital adequacy, valuation, profit/loss on sale of assets, income recognition and provisioning and accounting treatment for securitization transactions and disclosure norms. Attachment 4 is the format of quarterly reporting to the audit sub-committees of the board by originating banks of securitization transactions.

RDDBFI ACT 1993

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1993 The disconnect between the law and economics of the Civil Court era, is easily palpable, as shown by the 15 lakhs cases filed by the Banks a nd Financial Institutions which were pending. The fund blocked in the process of litigation was to the tune of Rs.5622crores of Public Sector Banks and Rs.391crores of Financial Institutions. Civil Courts failed to deliver both in the ascertainment of dues & the execution of decree. Hence came the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (RDDBFI Act). The desired results did not come from this Act either. It certainly brought down the time spent on adjudication of dues but however, failed to execute the Decree/Certificate in an effective way. This becomes evident from the fact that till about 30th September, 2001, 22 Debt Recovery Tribunals (DRTs) of the country had adjudicated 9814 cases, issuing the Certificate/Decree for Rs.6265crores, whereas the actual recoveries were only of Rs.1864crores. Of the two ills of the Civil Courts era, the non ascertainment of dues in an expeditious manner was cured by the RDDBFI Act, but it failed miserably in effectively executing the decree. The second Narsimhan Committee too, stressed that a strong and efficient financial system was necessary to strengthen the domestic economy and make it more efficient simultaneously enabling it to meet the challenges posed by financial globalization. It suggested the setting up RECONSTRUCTION COMPANYs rather than a fund to meet the challenges of NPAs. This set the ground work for planning a structure & setting up of a legal framework for Reconstruction Companys in India.

SARFAESI ACT 2002

Non-performing Assets of bad debts have always been a major destructive force for the Indian banking and financial industry. The Indian banks and financial institutions have always faced severe criticism for their inability to control their burgeoning non-performing assets or NPAs. Whenever a loan customer turns non-payer, the banks or the financial institutions find it ooperationally difficult to take control of the collateral or to utilise recovery procedures designed for a company that goes into bankruptcy. It was felt that there existed a regime of weak creditor rights and it was this situation that resulted in the building up of high NPAs in the banking system. The existing judiciary system was found to be ineffective in helping the banks, financial institutions and the lenders. To eliminate these problems , a new piece of legislation came into force and it was called the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 ('RDDBFI Act'). The RDDBFI Act envisaged a summary procedure for ascertainment of dues, but it failed to execute court orders or decrees in an effective way. This Act was also found to be ineffective in eliminating bank's NPA problems.
The Government in June 2002 introduced a new law entitled The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 ('the Act') that aimed to simplify the process of recovery of bad loans from wilful defaulters. The Act provides the first legal framework that recognises securitisation, asset recovery and reconstruction.

The genesis of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act (Securitization Act/SARFAESI Act) as we know lay in the earlier failure of the legal system to meet the demands exacted on it. This act, which came to effect on the 21st of June 2002, aimed to lay emphasis on recovery of the money, even without the intervention of Court. The Act provides for a number of matters including the registration and empowerment of asset reconstruction companies, as well as the regulation of the marketplace for non-performing assets.

The Act empowers RECONSTRUCTION COMPANYs to employ all methods available for asset reconstruction and recoveries including restructuring, settlement and sale of assets through enforcement of security rights. It also provides additional rights regarding sale/lease of management and business of the borrower. The Banks were empowered under Section 13(4)4 of Securitization Act to take possession of Secured Assets of the borrower including the right to transfer by way of lease, assignment or sale for realizing the Secured Asset. The earlier experience in terms of delays due to court intervention had soured the recovery of NPAs by financial institutions. Thus role of the Court was limited to challenge the measures under Section 13(4), which talks about the Enforcement of Security Interest. In essence the Securitization Act, 2002 concentrated only on the executing the decrees rather than the recovery or ascertainment of dues. The recovery aspect further received a setback when Supreme Court in Mardia Chemicals Vs. The Union of India struck down the condition for pre-deposit of 75% of amount ascertained by the Banks & not Courts of law as ultra vires of the Constitution. This effectively made the Act redundant for recovery of dues. The Act no doubt addressed an important need of the financial system when it set up a whole framework under which securitization & asset reconstruction would take place in India. The Act empowered banks to dispose of their bad assets & keep a clean balance sheet. Section 13 of the Act came as a boon to the banks who had been burdened as much by the systemic (read legal & procedural) delays as by the NPAs themselves. However, the Mardia Chemical judgment dampened spirits when the provision of deposit of 75% of the amount before appeal was struck down. The confusion & complications created have once again made appeals a cheap alternative for the erring borrowers. This today is one of the major impediments in the reconstruction of assets in India.

Key features of Securitisation Act, 2002:

Some important terms and their definitions:

1. **Borrower**: borrower means any person who has been granted financial assistance by any bank or financial institution or who has given any guarantee or created any mortgage or pledge as security for the financial assistance granted by any bank or financial institution and includes a person who becomes borrower of a securitisation company or reconstruction company consequent upon acquisition by it of any rights or interest of any bank or financial institution in relation to such financial assistance;

2. **Financial Asset:** Financial asset means debt or receivables and includes-

   (i) a claim to any debt or receivables or part thereof, whether secured or unsecured; or

   (ii) any debt or receivables secured by, mortgage of, or charge on, immovable property; or

   (iii) a mortgage, charge, hypothecation or pledge of movable property; or

   (iv) any right or interest in the security, whether full or part underlying such debt or receivables; or

(v) any beneficial interest in property, whether movable or immovable, or in such debt, receivables, whether such interest is existing, future, accruing, conditional or contingent; or

(vi) any financial assistance;

3. **<u>Financial Institution</u>:** Financial institution means-

(i) a public financial institution within the meaning of section 4A of the Companies Act, 1956 (1 of 1956)

(ii) any institution specified by the Central Government under sub-clause (ii) of clause (h) of section 2 of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (51 of 1993)

(iii) the International Finance Corporation established under the International Finance Corporation (Status, Immunities and Privileges) Act, 1958 (42 of 1958)

(iv) any other institution or non-banking financial company as defined in clause (f) of section 45-I of the Reserve Bank of India Act, 1934 (2 of 1934), which the Central Government may, by notification, specify as financial institution for the purposes of this Act;

4. **<u>Hypothecation:</u>** Hypothecation means a charge in or upon any movable property, existing or future, created by a borrower in favour of a secured creditor without delivery of possession of the movable property to such creditor, as a security for financial assistance and includes floating charge on movable property.

5. **<u>Non-performing Assets (NPAs):</u>** Non-performing asset means an asset or account of a borrower, which has been classified by a bank or financial institution as sub-standard, doubtful or loss asset, in accordance with the directions or under guidelines relating to assets classifications issued by the Reserve Bank

6. **<u>Obligor</u>** : Obligor means a person liable to the originator, whether under a contract or otherwise, to pay a financial asset or to discharge any obligation in respect of a financial asset, whether existing, future, conditional or contingent and includes the borrower.

7. **<u>Originator</u>:** Originator means the owner of a financial asset which is acquired by a securitisation company or reconstruction company for the purpose of securitisation or asset reconstruction.

8. **Qualified Institutional Buyer:** Qualified Institutional Buyer means a financial institution, insurance company, bank, state financial corporation, state industrial development corporation, trustee or any asset management company making investment on behalf of mutual fund or provident fund or gratuity fund or pension fund or a foreign institutional investor registered under the Securities and Exchange Board of India Act, 1992 (15 of 1992) or regulations made thereunder, or any other body corporate as may be specified by the Board.

9. **Reconstruction company:** Reconstruction company means a company formed and registered under the Companies Act, 1956 (1 of 1956) for the purpose of asset reconstruction.

10. **Securitisation:** Securitisation means acquisition of financial assets by any securitisation company or reconstruction company from any originator, whether by raising of funds by such securitisation company or reconstruction company from qualified institutional buyers by issue of security receipts representing undivided interest in such financial assets or otherwise.

(7) DOING BUSINEES OF SECURITISATION

When can a securitisation company start its business?

According to Section 3 of the Securitisation Act, 2002, a securitisation company or reconstruction company can its commence or carry on the business of securitisation or asset reconstruction only after it

(a) obtains a certificate of registration granted under this section; and

(b) has the owned fund of not less than two crore rupees or such other amount not exceeding fifteen per cent. of total financial assets acquired or to be acquired by the securitisation company or reconstruction company, as the Reserve Bank may, by notification, specify. However, in some cases, the Reserve Bank may, by notification, specify different amounts of owned fund for different class or classes of securitisation companies or reconstruction companies.

The Reserve Bank has the powers [under Section 3(3)] to be satisfied, by an inspection of records or books of such securitisation company or reconstruction company, or otherwise, that the following conditions are fulfilled, namely:-

(a) that the securitisation company or reconstruction company has not incurred losses in any of the three preceding financial years;

(b) that such securitisation company or reconstruction company has made adequate arrangements for realisation of the financial assets acquired for the purpose of securitisation or asset reconstruction and shall be able to pay periodical returns and redeem on respective due dates on the investments made in the company by the qualified institutional buyers or other persons;

(c) that the directors of securitisation company or reconstruction company have adequate professional experience in matters related to finance, securitisation and reconstruction;

(d) that the board of directors of such securitisation company or reconstruction company does not consist of more than half of its total number of directors who are either nominees of any sponsor or associated in any manner with the sponsor or any of its subsidiaries;

(e) that any of its directors has not been convicted of any offence involving moral turpitude;

(f) that a sponsor, is not a holding company of the securitisation company or reconstruction company, as the case may be, or, does not otherwise hold any controlling interest in such securitisation company or reconstruction company;

(g) that securitisation company or reconstruction company has complied with or is in a position to comply with prudential norms specified by the Reserve Bank.

The Reserve Bank may grant a certificate of registration to the securitisation company or the reconstruction company to commence or carry on business of securitisation or asset reconstruction only after the above-mentioned conditions are fulfilled. In some cases, the Reserve Bank may impose additional conditions to be satisfied before the securitisation company commences its operations. The Reserve Bank may reject the application made if it is satisfied that the conditions specified in sub-section (3) are not fulfilled. However, the RBI can reject the application only after the applicant is given a reasonable opportunity of being heard.

What happens in case there is a change in the management of the securitisation company?

Section 3 (6) says that every securitisation company or reconstruction company is required to obtain prior approval of the Reserve Bank for any substantial change in its management or change of location of its registered office or change in its name and in such a case, it is the prerogative of the RBI to decide whether the change in management of a securitisation company or a reconstruction company is a substantial change in its management or not.

Explanation.-For the purposes of this section, the expression substantial change in management means the change in the management by way of transfer of shares or amalgamation or transfer of the business of the company.

When can the certificate of registration be cancelled?

Under Section 4 of the Securitisation Act, 2002, the Reserve Bank may cancel a certificate of registration granted to a securitisation company or a reconstruction company, if such company-

(a) ceases to carry on the business of securitisation or asset reconstruction; or

(b) ceases to receive or hold any investment from a qualified institutional buyer; or

(c) has failed to comply with any conditions subject to which the certificate of registration has been granted to it; or

(d) at any time fails to fulfil any of the conditions referred to in clauses (a) to (g) of sub-section (3) of section 3; or

(e) fails to-

(i) comply with any direction issued by the Reserve Bank under the provisions of this Act; or

(ii) maintain accounts in accordance with the requirements of any law or any direction or order issued by the Reserve Bank under the provisions of this Act; or

(iii) submit or offer for inspection its books of account or other relevant documents when so demanded by the Reserve Bank; or

(iv) obtain prior approval of the Reserve Bank required under sub-section (6) of section 3 i.e., obtaining prior approval with respect to any substantial changes in the management of the company.

However, in case the RBI feels that the canceling of registration certificate may be prejudicial to the public interest or the interests of the investors or the securitisation company or the reconstruction company, then the RBI may give an opportunity to such company on such terms as the Reserve Bank may specify for taking necessary steps to comply with such provisions or fulfillment of such conditions.

What are the options before a Securitisation company if its certificate is cancelled?

A securitisation company or reconstruction company aggrieved by the order of rejection of application for registration or cancellation of certificate of registration may prefer an appeal, within a period of thirty days from the date on which such order of rejection or cancellation is communicated to it, to the Central Government.rtunity of being heard.

What happens to the QIB if the certificate of registration is canceled?

When the assets of a securitisation company are held by the investments of qualified institutional buyers, notwithstanding such rejection or cancellation, the securitisation is still deemed to be a securitisation company or until it repays the entire investments held by it (together with interest, if any) within such period as the Reserve Bank may direct.

Differences between RDDBI Act, 1993 and SARFAESI Act, 2002:

In the year 2002, the Government of India came out with a sleuth of reforms in the financial sector which an impetus to many new events in the financial world. One of the important pieces of legislation that the Government introduced was with respect to securitization transactions in the financial world. When the SARFAESI Act, 2002 came into force, there was a dire need to empower and enable the Banks to speedily recover their loans. The earlier Acts failed to provide enough teeth to the Banks to do it themselves without approaching the Civil Courts. As such, the banks could not effectively recover the loans in time and as a result Banks tremendous amount of problems in terms of Non-performing Assets. It was due to this reason, the "Recovery of Debts Due to Banks and Financial Institutions Act, 1993" was enacted enabling the Bank to approach the Special Tribunal called "Debt Recovery Tribunal". Under this Act, the banks were required to get a declaration as to the outstanding due from the borrowers and to get the declaration executed in order to recover their loans. However, inspite of this Act, the Banks could not reduce their Non-performing Assets (NPA). Thus, this compelling reason of NPAs paved way for the enactment of "Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002". Under the SARFAESI Act, 2002, Banks can follow a procedure to determine the outstanding due on their own and they will take such steps required in accordance with the Act in realizing their due. This Act gave Banks the following powers to recover their dues: Firstly, the banks were to

a) make a demand under section 13 (2) of the Act, thereafter
b) receive objections from the borrowers,
c) reply to the objections from the borrowers under section 13 (3A) within the prescribed time,
d) take symbolic possession of the property under section 13 (4),
e) take physical possession of the property/secured asset with the help of the Magistrate under section 14 and
f) conduct an auction of the property mortgaged in accordance with the provisions of the Act and rules.

While the borrowers are provided with a right to appeal to the Debt Recovery Tribunal under section 17 of the Act if they are aggrieved at the action initiated by the Bank and the borrower can exercise their right of appeal as against any action by the Bank pursuant to section 13 (4) of the SARFAESI Act, 2002.

Though the objective of this new piece of legislation was to further the objective of RDDBI Act, 1993, however, in principle there were some major differences between the two laws. Now let us briefly examine and understand what those differences are:

The primary objective of SARFAESI Act, 2002 was to reduce the delay in the process of adjudication between the Banks and its borrowers. The question of recovery by the Banks and Financial Institutions will arise when the borrowers commit default in repaying the debt. When there is default, then, the Banks will categorize the account as "Non-performing Asset" in accordance with the norms prescribed by the Reserve Bank of India.

The main difference between RDDBI Act, 1993 and SARFAESI Act, 2002 is as follows:

The RDDBI Act, 1993 enables the Bank to approach the Tribunals when the debt exceeds the prescribed limit and under this Act, it is the Debt Recovery Tribunal that will adjudicate the amount due and passes the final award.

Whereas, the SAFAESI Act, 2002, allows a procedure, wherein the Bank or Public Financial Institution themselves can adjudicate the debt. Only after adjudication by the Bank, the borrower is given right to prefer an appeal to the Tribunal under SARFAESI Act, 2002. The Banks or Financial Institutions can invoke the provisions of SAFAESI Act, 2002 only in respect of secured assets and not all. Thus, under SARFAESI Act, 2002, the Banks are given powers under section 13 to carry out the adjudication exercise.

(8) Securitization Model

RECONSTRUCTION COMPANY functions more or less like a Mutual Fund. It transfers the acquired assets to one or more trusts (set up u/s 7(1) and 7(2) of SRFAESI Act, 2002) at the price at which the financial assets were acquired from the originator (Banks/FIs).

Then, the trusts issues Security Receipts to Qualified Institutional Buyers [as defined u/s 2(u) of SRFAESI Act, 2002]. The trusteeship of such trusts shall vest with the Reconstruction Company. Reconstruction Company will get only management fee from the trusts. Any upside in between acquired price and realized price will be shared with the beneficiary of the trusts (Banks/FIs) and Reconstruction Company. Any downside in between acquired price and realized price will be borne by the beneficiary of the trusts (Banks/FIs).

Most securitizations in India adopt a trust structure. In this structure the underlying assets being transferred by way of a sale to a trustee, who holds it in trust. A trust is not a legal entity in law – but a trustee is entitled to hold property which is distinct from the property of the trustee or other trust properties held by it .

The Trust issues securities which are either "pass through securities" or "pay through securities". In case of pass through securities, the investors owning/buying these securities acquire beneficial interest in the underlying assets held by the trustee. While, pay through securities are different as investors holding them acquire beneficial interest only in the cash flows realized from the underlying assets and that too in the order of and to the extent of the obligation contracted with the holders of the respective senior and subordinated tranches of pay through securities.

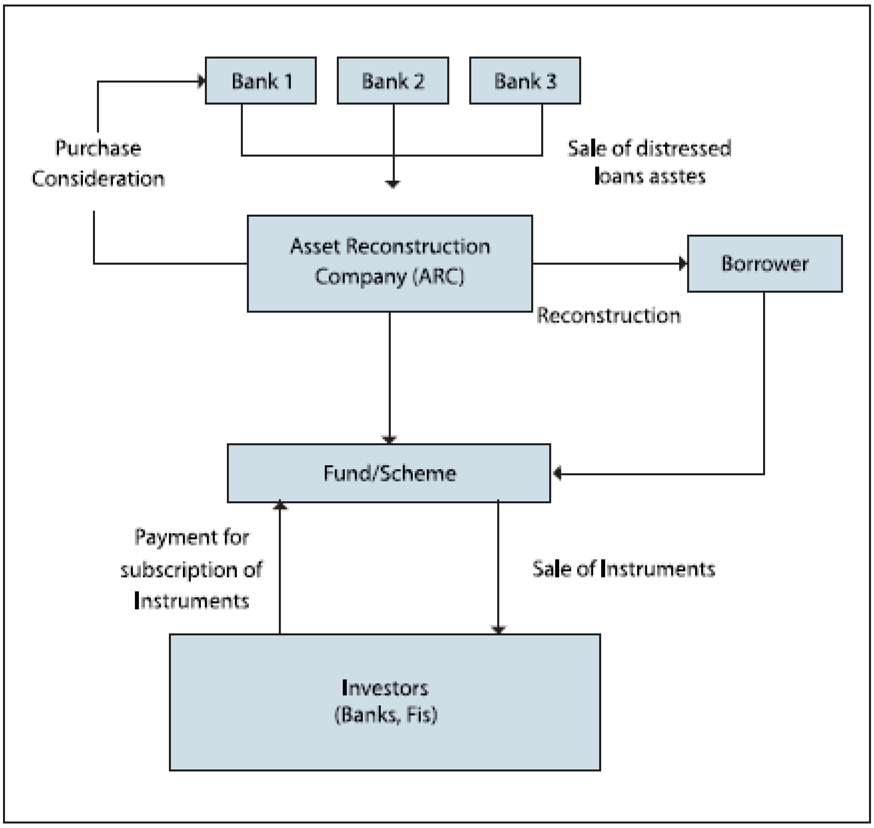
A generic business model of a typical Reconstruction Company is to buy distressed assets from a Bank/Financial Institutions; and then either directy securitize the asset or first reconstruct the asset and then securitize it to sell it to investors. The schematic representation of the business model is presented below. It shows the various transactional flows between various participants, which are described below. The following are the participants in a typical Asset Reconstruction Transaction:

1. Banks/FIs: They sell their distressed assets to the RECONSTRUCTION COMPANY & are also referred to the originators
2. RECONSTRUCTION COMPANY/ Trust: The RECONSTRUCTION COMPANY forms a SPV (Special Purpose Vehicle) which can issue security receipts which are Pass through Certificates for the cash flows from the assets
3. Investors: They are of different classes, and thus the RECONSTRUCTION COMPANY structures the cash flows into different schemes to suit these classes. They are the final owners of the cash flows from assets
4. Borrower: It is the company which had borrowed the money and is in financial distress

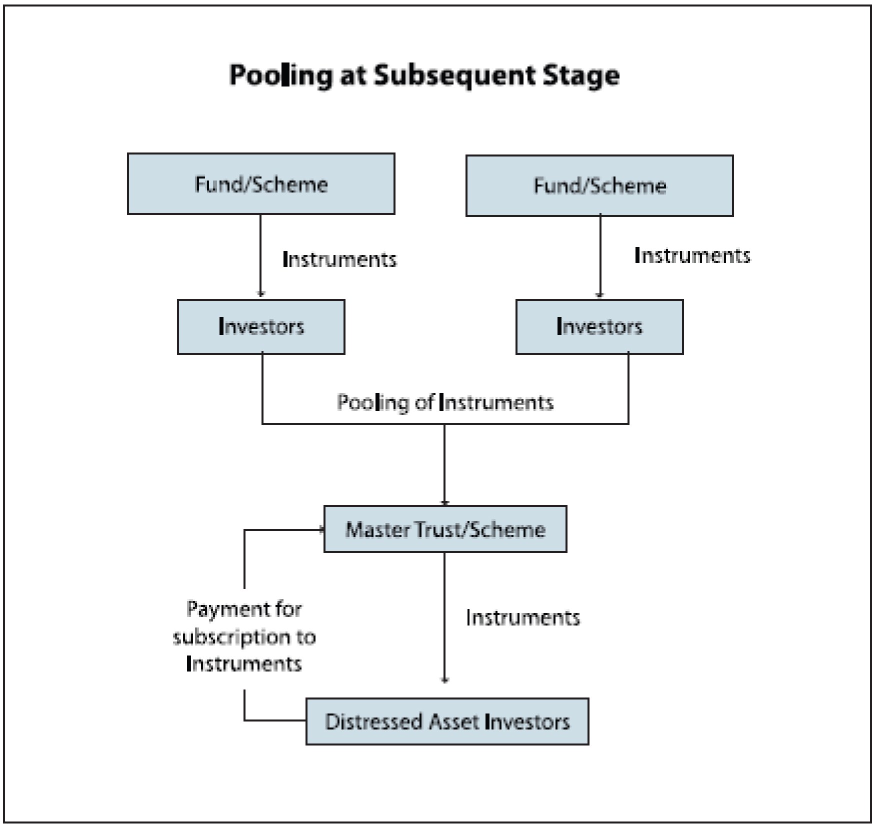
Transaction Structures
Stage 1:

1. Initially, an RECONSTRUCTION COMPANY acquires NPA by floating an Special Purpose Vehicle (SPV) which acts as a trust whereby the RECONSTRUCTION COMPANY is a trustee and manager. NPA are acquired from banks/FIs at fair value based on assessment of realisable amount and time to resolution. The banks/FIs may receive cash/bonds/debentures as consideration or may invest in securities issued by the RECONSTRUCTION COMPANYs.

   The trust acquires NPAs from banks/FIs and raises resources by formulating schemes for the financial assets taken over. Accordingly, it issues securities to the investors which are usually Qualified Institutional Buyers(QIB). Securities represent undivided right, title and interest in the trust fund. Subsequently, the RECONSTRUCTION COMPANY redeems the investment to the bank/FIs out of the funds received from the issued securities. After acquiring the NPA, the trust becomes the legal owner and the security holders its immediate beneficiaries. The NPAs acquired are held in an asset specific or portfolio trust scheme. In the portfolio approach, due to the small size of the aggregate debt the RECONSTRUCTION COMPANY makes a portfolio of the loan assets from different banks and FIs. Whereas when the size of the aggregate debt of a bank/FI is large, the trust takes asset specific approach.



Stage 2: Thereafter, different fund schemes are pooled together in a master trust scheme and sold to other investors. The RECONSTRUCTION COMPANY periodically declares the NAV of respective schemes.



Basic Structures of Asset-Backed Securities

A security's structure is often dictated by the kind of collateral supporting it. Installment loans dictate a quite different structure from revolving lines of credit. Installment loans, such as those made for the purchase of automobiles, trucks, recreational vehicles, and boats, have defined amortization schedules and fixed final maturity dates. Revolving loans, such as those extended to credit card holders and some home equity borrowers, have no specific amortization schedule or final maturity date. Revolving loans can be extended and repaid repeatedly over time, more or less at the discretion of the borrower.

Installment Contract Asset-Backed Securities

Typical installment contract asset-backed securities, which bear a close structural resemblance to mortgage pass-through securities, provide investors with an undivided interest in a specific pool of assets owned by a trust. The trust is established by pooling installment loan contracts on automobiles, boats, or other assets purchased from a loan originator, often a bank. The repayment terms for most installment contract asset-backed securities call for investors to receive a pro rata portion of all of the interest and principal received by the trust each month. Investors receive monthly interest on the outstanding balance of their certificates, including a full month's interest on any prepayments. The amount of principal included in each payment depends on the amortization and prepayment rate of the underlying collateral. Faster prepayments shorten the average life of the issue.

Revolving Asset Transactions

The typically short lives of receivables associated with revolving loan products (credit cards, home equity lines, etc.) require issuers to modify the structures used to securitize the assets. For example, a static portfolio of credit card receivables typically has a life of between five months and ten months. Because such a life is far too short for efficient security issuance, securities backed by revolving loans are structured in a manner to facilitate management of the cash flows. Rather than distributing principal and interest to investors as received, the securities distribute cash flow in stages —
A revolving phase followed by an amortization phase. During the revolving period, only interest is paid and principal payments are reinvested in additional receivables as, for example, customers use their credit cards or take additional draws on their home equity lines. At the end of the revolving period an amortization phase begins, and principal payments are made to investors along with interest payments. Because the principal balances are repaid over a short time, the life of the security is largely determined by the length of the revolving period.

(9) RECONSTRUCTION COMPANY

The word "Reconstruction company "

The word asset reconstruction company is a typical Indian word - the global equivalent of which is asset management companies. The word "asset reconstruction" in India owes its origin to Narsimham I which envisaged the setting up of a Central Asset Reconstruction Fund with money contributed by the Central Government, which was to be used by banks to shore up their balance sheets to clean up their non-performing loans. This idea never worked: so Narsimham II thought of asset reconstruction companies, the likes of which had already been successful in Malaysia, Korea and several other countries in the World. To keep the tune the same as the original idea of asset reconstruction fund, as also to give an impression that RECONSTRUCTION COMPANYs are not merely concerned with realisation of bad loans but they are going to do "reconstruction", that is, try and resurrect bad loans into good ones, the word RECONSTRUCTION COMPANY has been used in India.

Need for Reconstruction company

In last 15 years or so the a number of economies around the world have witnessed the problem of nonperforming assets. A high level of NPAs in the banking system can severely affect the economy in many ways. The high level of NPAs leads to diversion of banking resources towards resolution of this problems. This causes an opportunity loss for more productive use of resources. The banks tend to become risk averse in making new loans, particularly to small and medium sized companies. Thus, large scale NPAs when left unattended, cause continued economic and financial degradation of the country. The realization of these problems has lead to greater attention to resolve the NPAs. RECONSTRUCTION COMPANYs have been used world-wide, particularly in Asia, to resolve bad-loan problems.

Asset Reconstruction companies have been set up in various countries internationally as an answer to the global problem of bad loans.

Bad loans are essentially of two types: bad loans generated out of the usual banking operations or bad lending, and bad loans which emanate out of a systematic banking crisis.

It is in the latter case that banking regulators or governments try to bail out the banking system of a systematic accumulation of bad loans which acts as a drag on their liquidity, balance sheets and generally the health of banking. So, the idea of AMCs or Reconstruction Companies is not to bail out banks, but to bail out the banking system itself.

There are essentially two approaches to taking care of these systematic bail out efforts: one, leave the banks to manage their own bad loans by giving them incentives, legislative powers, or special accounting or fiscal advantages. The second approach is to do the same thing on a concerted, central level, through a centralised agency or agencies.

The former approach is called the **decentralised approach** and the latter approach is called **centralised approach**. RECONSTRUCTION COMPANYs arise out of the second approach - that is, a centralised agency for resolving bad loans created out of a systematic crisis.

Each approach has its own advantages and disadvantages and there is no clear evidence of any of the two being better over the other. Various countries have tried either of the two approaches with success stories and failures in either case.

However, these had a varying degree of success in different countries. Reconstruction Ccmpanies focus on NPAs and allows the banking system to act as "clean bank".

Reconstruction Company in India :

In India the problem of recovery from NPAs was recognized in 1997 by Government of India. The Narasimhan Committee Report mentioned that an important aspect of the continuing reform process was to reduce the high level of NPAs as a means of banking sector reform. It was expected that with a combination of policy and institutional development, new NPAs in future could be lower. However, the huge backlog of existing NPAs continued to hound the banking sector. It impinged severely on banks performance and their profitability. The Report envisaged creation of an "Asset Recovery Fund" to take the NPAs off the lender's books at a discount.

Accordingly, Asset Reconstruction Company (Securitization Company / Reconstruction Company) is a company registered under Section 3 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SRFAESI) Act, 2002. It is regulated by Reserve Bank of India as an Non Banking Financial Company (u/s 45I (f) (iii) of RBI Act, 1934).

RBI has exempted RECONSTRUCTION COMPANYs from the compliances under section 45-IA, 45-IB and 45-IC of the Reserve Bank Act, 1934. RECONSTRUCTION COMPANY functions like an AMC within the guidelines issued by RBI.

RECONSTRUCTION COMPANY has been set up to provide a focused approach to Non-Performing Loans resolution issue by:-

(a) Isolating Non Performing Loans (NPLs) from the Financial System (FS),
(b) Freeing the financial system to focus on their core activities
(c) Facilitating development of market for distressed assets.
(d) To manage these bad loans on a concerted, central level, through a centralized agency or agencies. (Centralized Approach). RECONSTRUCTION COMPANYs are examples of this approach.

The advantages of the Centralized Approach are as follows:

i. More clout and controllability as bad loans in one or a few hands
ii. Easier and Safer to give special legislative powers to a single (few) firms than the whole banking system
iii. Regular banking unaffected with lesser burden on their balance sheets
iv. Economies of scale, it can mix up good assets with bad ones and make a sale which is palatable to buyers.
v. Funding is easier for an Reconstruction Company than banks themselves

Functions of Reconstruction Company :

As per RBI Notification No. DNBS.2/CGM(CSM)-2003, dated April 23, 2003, RECONSTRUCTION COMPANY performs the following functions :-

(i) Acquisition of financial assets (as defined u/s 2(L) of SRFAESI Act, 2002)
(ii) Change or takeover of Management / Sale or Lease of Business of the Borrower
(iii) Rescheduling of Debts
(iv) Enforcement of Security Interest (as per section 13(4) of SRFAESI Act, 2002)
(v) Settlement of dues payable by the borrower

(10) FUNCTIONING OF RECONSTRUCTION COMPANY

1) The first step which initiates the process is the selling of distressed debt/asset (NPA) by the bank to an reconstruction company.

2) The banks transfer the security receipts to the reconstruction company. This essentially means that the cash flows from the sold off debt belong to the reconstruction company.

3) The Reconstruction Company, in the second stage, involves itself into the resolution stage, may/may not get involved in the Management (by a complete buyout). It restructures the capital structure and arranges various kinds of investments for servicing the debt for the company in distress. This represents the 1st investment opportunity (discussed shortly in the next section).
4) In the last stage, the company comes out with a debt issue for the credit enhanced company (enhancement done in 2nd stage) to the risk-averse investors. Thus the trust gets back the investment (or a part of it), that it had made initially in buying the assets from the bank.

Requirements for reconstruction instrument

An reconstruction company instrument for being palatable for investors must have a certain set of characteristics. The ones discussed below were among the major requirements that an reconstruction company instrument would need.

Marketability:
It is the very purpose for which an reconstruction company exists, i.e. to create liquidity for the otherwise illiquid assets of the banking system

The concept involves two postulates, one regarding the legal issues and legal feasibility of marketing the instrument & the other being existence of a market for the instrument.

Credibility in the issuer & Credit enhancer:
The investor demand of the securitized receipts depends on the credibility of an reconstruction company and of the credit enhancements if provided by the 3rd party. This is requires the reconstruction companys to have successfully established themselves and generated enough trust in the investment community.

Transparency:
The transparency of the issuer with respect to disclosure of the distressed debt and its restructuring process to ensure invest or trust is important.

Wide Distribution:
To achieve greater penetration the extent of distribution which the originator would like to achieve is based on a comparative analysis of the costs and the benefits achieved thereby. The benefits of wider distribution are that it's able to market the product with lower return, and hence, lower financial cost. While the cost involved are that of distribution and servicing.

Homogeneity:
To be marketable, the instrument should be packaged as into homogenous lots. Most securitized instruments are sliced into smaller lots such that they are affordable to the marginal investor. Thus the minimum denomination becomes relative to the needs of the smallest investor.

Special Purpose Vehicle:
In most cases the securitization involves assets or claims which need to be integrated and differentiated, that is, unless it is a direct and unsecured claim on the issuer, the issuer will need an intermediary agency to act as a repository of the asset or claim which is being securitized. For this purpose, the issuer will bring in a mediating agency whose basic function is to hold the security charge on behalf of the investors, and issue certificates to the investors of beneficial interest in the charge held by the intermediary.

(11) INCORPORATING RECONSTRUCTION COMPANY

Section 3 Registration of securitisation companies or reconstruction companies

(1) No securitisation company or reconstruction company shall commence or carry on the business of securitisation or asset reconstruction without--

(a) Obtaining a certificate of registration granted under this section; and
(b) having the owned fund of not less than two crore rupees or such other amount not exceeding fifteen per cent of total financial assets acquired or to be acquired by the

securitisation company or reconstruction company, as the Reserve Bank may, by notification, specify:

PROVIDED that the Reserve Bank may, by notification, specify different amounts of owned fund for different class or classes of securitisation companies or reconstruction companies:

PROVIDED FURTHER that a securitisation company or reconstruction company, existing on the commencement of this Act, shall make an application for registration to the Reserve Bank before the expiry of six months from such commencement and notwithstanding anything contained in this sub-section may continue to carry on the business of securitisation or asset reconstruction until a certificate of registration is granted to it or, as the case may be, rejection of application for registration is communicated to it.

(2) Every securitisation company or reconstruction company shall make an application for registration to the Reserve Bank in such form and manner as it may specify.

(3) The Reserve Bank may, for the purpose of considering the application for registration of a securitisation company or reconstruction company to commence or carry on the business of securitisation or asset reconstruction, as the case may be, require to be satisfied, by an inspection of records or books of such securitisation company or reconstruction company, or otherwise, that the following conditions are fulfilled, namely:--

(a) that the securitisation company or reconstruction company has not incurred losses in any of the three preceding financial years;
(b) that such securitisation company or reconstruction company has made adequate arrangements for realisation of the financial assets acquired for the purpose of securitisation or asset reconstruction and shall be able to pay periodical returns and redeem on respective due dates on the investments made in the company by the qualified institutional buyers or other persons;
(c) that the directors of securitisation company or reconstruction company have adequate professional experience in matters related to finance, securitisation and reconstruction;

(d) that the board of directors of such securitisation company or reconstruction company does not consist of more than half of its total number of directors who are either nominees of any sponsor or associated in any manner with the sponsor or any of its subsidiaries;
(e) that any of its directors has not been convicted of any offence involving moral turpitude;
(f) that a sponsor, is not a holding company of the securitisation company or reconstruction company, as the case may be, or, does not otherwise hold any controlling interest in such securitisation company or reconstruction company;
(g) that securitisation company or reconstruction company has complied with or is in a position to comply with prudential norms specified by the Reserve Bank.

(h) that securitisation company or reconstruction company has complied with one or more conditions specified in the guidelines issued by the Reserve Bank for the said purpose.

(4) The Reserve Bank may, after being satisfied that the conditions specified in sub-section (3) are fulfilled, grant a certificate of registration to the securitisation company or the reconstruction company to commence or carry on business of securitisation or asset reconstruction, subject to such conditions which it may consider, fit to impose.

(5) The Reserve Bank may reject the application made under sub-section (2) if it is satisfied that the conditions specified in sub-section (3) are not fulfilled:
PROVIDED that before rejecting the application, the applicant shall be given a reasonable opportunity of being heard.

(6) Every securitisation company or reconstruction company shall obtain prior approval of the Reserve Bank for any substantial change in its management or change of location of its registered office or change in its name:
PROVIDED that the decision of the Reserve Bank, whether the change in management of a securitisation company or a reconstruction company is a substantial change in its management or not, shall be final.

Explanation
: For the purposes of this section, the expression "substantial change in management" means the change in the management by way of transfer of shares or amalgamation or transfer of the business of the company.

Background

This section provides for compulsory registration of securitisation companies or reconstruction companies. Such registration is compulsory also in caseo companies already carrying on securitisation or asset reconstruction business as at the commencement of the Act. Application for registration shall be made in prescribed form and manner laid down. Conditions for registration has been laid down in sub-section(3), certificate of registration will be granted only after conditions so specified have been satisfied.

MANDATORY REGISTRATION

Subsection (1) does not prohibit the carrying on the business of secuitisation or asset reconstruction to entities other than companies and such entities may be in the form of an individual enterprise or a partnership firm.

However it is mandatory in case of companies to get itself register with RBI under section 3.

Though entities other than companies are not mandated to obtain from RBI a certificate of registration under section 3, they will not have following powers without registration.

(i) To acquire under section 5 of the Act, any right or any interest in any financial asset of Banks or Financial Institutions

(ii) To proceed for enforcement of its security interest as provided in section 13 of the act.

(iii) To take any of the measures for asset reconstruction against a borrower as contemplated under section 9 of the act.

(iv) To approach a Metropolitan Magistrate or a District Magistrate to assist such entity in taking possession from the borrower of the secured asset.

CONDITIONS FOR REGISTRATION

A securitisation or reconstruction company desirous of obtaining a certificate of registration from the Reserve Bank of India under section3, must-

(i) Own fund not less than rupees two crore: or

(ii) Such other amount not exceeding fifteen per cent of total financial assets acquired or to be acquired by the securitisation company or reconstruction company, as the Reserve Bank may, by notification, specify:

Subsection 3 uses the word Fund and not Capital. There is minor difference between the word Capital and Fund.

Capital is – Money or assets invested or a available for investment in a business. The total assets of a business i.e those that help generate profits.

Fund denotes- Money or the assets such as, stocks, bonds or working capital available to pay any debts, expenses and the like. A sum of money or other liquid assets established for a specific purpose- a fund reserved for unanticipated purpose.

Registration with RBI in addition to registration under Companies Act

"Securitisation company" means any company formed and registered under the Companies Act, 1956 (1 of 1956) for the purpose of securitisation;

"Reconstruction company" means a company formed and registered under the Companies Act, 1956 (1 of 1956) for the purpose of asset reconstruction;

Above two definitions clearly states that a company engaged in the business of securitisation or asset reconstruction must exist as company duly registered under the Companies Act m and also seek additional registration with the Reserve Bank of India in accordance with provision of section 3 of the Act, which is a mandatory requirement before commencement of its business.

Incorporation under Companies Act Private of Public Company

Section 3 states that the securitisatio nor the reconstruction company, as such ahs to be formed and registered under the Companies Act, and no specification has been made whether it should be private or public limited company.

The requirement is to be registered under the provision of the Companies Act 1956

The provisions relating to incorporation of companies and matters incidental thereto are contained in section 11 to 54 of the Companies Act, 1956.
A certificate of incorporation given by the Registrar in respect of any association shall be conclusive evidence that all the requirements of the Companies Act, 1956

RBI may specify different amount of owned fund for different classes of securitisation companies
The first proviso to sub-section (1) states that in order to commence or carry on the business of securitisation or asset reconstruction, the securitisation or the reconstruction company must have, with it, its own fund of not less than two crore rupees, or such other amount not exceeding fifteen percent of total financial assets acquired or to be acquired by such company as the RBI may specify
It means that the RBI has power to specify such owned fund to be even more than two crore rupees. The word 'or' placed before the expression 'such other amount' is a pointer to the discretion of the RBI to specify, or not at all to specify such other amount. If any amount is specified it should be same for class of companies to which the particular securitisation or the reconstruction company may belong.

Existing securitisation company or reconstruction company to apply for registration
Sub-section (1) of section3, has envisaged the following two categories of securitisation or reconstruction companies
(i) A company which shall commence its business after the commencement of the Act and
(ii) A company which carries on its business even at time of commencement of the Act

However second proviso has only allowed time of six months to such companies, which are already in the business of securitisation or asset reconstruction, for submitting their application for registration under section3. Such company may continue to carry on its business pending grant of certificate of registration or till rejection of its application for certificate of registration.

Single company can carry on business of both securitisation and reconstruction
Sub-section (1) to section 3 states that "No securitisation company or reconstruction company shall commence or carry on the business of securitisation or asset reconstruction without obtaining certificate of registration"
It appears from the above that separate registration is required for carrying on the business of securitisation of reconstruction. However a company whether registered as a securitisation company or a reconstruction company can carry on the business either of securitisation or asset reconstruction or both at its own choice. There is no compulsion on a securitisation company or a reconstruction company to engage itself in both types of business.
A securitisation or reconstruction company may also commence or carry on any business other than that of securitisation or asset reconstruction with prior approval of RBI.

Application for registration

Sub-section states that "every securitisation company or reconstruction company shall make an application for registration to the Reserve Bank in such form and manner as it may specify"

The use of the work 'shall' means that failure to make an application in the prescribed form or failure to conform to the manner so specified by the RBI for making such application may lead to summary rejection of the application. Where a provision prescribing an act to be done in particular manner is stated, it mandates that the act cannot be done in any other manner.

The RBI has prescribed the procedure and the form in which an application has to be made for certificate of registration is to be made.

Procession of application

Sub-section (3) provides that the Reserve Bank may, for the purpose of considering the application for registration of a securitisation company or reconstruction company to commence or carry on the business of securitisation or asset reconstruction, as the case may be, require to be satisfied, that the applicant company has fulfilled all the conditions enumerated in clauses (a) to (h) of this sub-section.

For satisfying itself that the condition have been fulfilled, the RBI can make an inspection of records or books of the applicant company and can carry on inspection to satisfy itself that conditions have been fulfilled. RBI apart from making inspection can also call for any further information or can make any other probe to ensure itself of the eligibility of the applying company.

Conditions for registration

Eight conditions have been laid down under clauses (a) to (h) of sub-section 3, which must be fulfilled by securitisation company or reconstruction company seeking a certificate of registration for commencing or carrying on its business. The conditions laid down are cumulative and not isolated.

The conditions are as follows

(a) The securitisation company or reconstruction company has not incurred losses in any of the three preceding financial years. This condition applies to securitisation or reconstruction company already existing and engaged in the business of securitisation and/or asset reconstruction on the date of commencement of the Act as a company seeking to commence its business after commencement of Act cannot have any profit or loss for any preceding three years

(b) Such securitisation company or reconstruction company has made adequate arrangements for realisation of the financial assets acquired for the purpose of securitisation or asset reconstruction and shall be able to pay periodical returns and redeem on respective due dates on the investments made in the company by the qualified institutional buyers or other persons. Hence the applying company should be financially sound and viable as to vouch for payment to qualified institutional buyers who have invested in its securities.

(c) The directors of securitisation company or reconstruction company have adequate professional experience in matters related to finance, securitisation and reconstruction;

(d) that the board of directors of applying company does not consist of more than half of its total number of directors who are nominees of any **sponsor** or associated in any manner with the sponsor or any of its subsidiaries

Sponsor means a person holding not less than ten percent of the paid-up equity capital of the applying company.

Meaning of" holding company" and" subsidiary" as per section 4 Companies Act 1956

(1) For the purposes of this Act, a company shall, subject to the provisions of sub- section (3), be deemed to be a subsidiary of another if, but only if,--

(a) that other controls the composition of its Board of directors; or

(b) that other-

(i) where the first- mentioned company is an existing company in respect of which the holders of preference shares issued before the commencement of this Act have the same voting rights in all respects as the holders of equity shares, exercises or controls more than half of the total voting power of such company;

(ii) where the first- mentioned company is any other company, holds more than half in nominal value of its equity share capital; or

(c) the first- mentioned company is a subsidiary of any com- pany which is that other' s subsidiary.

(e) Any of its directors has not been convicted of any offence involving moral turpitude

The term moral turpitude is not defined anywhere. Anything done contrary to justice, honesty modesty or good morals. The offences punishable under sections 419, 420 and 467 of the Indian Penal Code would definitely involve moral turpitude.

(f) The sponsor, is not a holding company of the securitisation company or reconstruction company, as the case may be, or, does not otherwise hold any controlling interest in such securitisation company or reconstruction company

(g) The applying company has complied with or is in a position to comply with prudential norms specified by the Reserve Bank.

(h) The applying company has complied with one or more conditions specified in the guidelines issued by the Reserve Bank for the said purpose.

Certificate of Registration

Grant of Certificate

Sub-section(4) of sstates the the Reserve Bank may, after being satisfied that the conditions specified in sub-section (3) are fulfilled, grant a certificate of registration to the securitisation company or the reconstruction company to commence or carry on business of securitisation or asset reconstruction, subject to such conditions which it may consider, fit to impose.

Whether RBI has discretion whether or not to issue certificate

The word may is usually constructed as permissive or directory. However when the provision is concerned with power to authority and the conditions for exercise of a power on part has been fulfilled the word may has to be constructed as shall and the word may is merely used as a mark of respect. The power exercisable in public interest must be exercised when the statutory conditions for exercise of that power have been fulfilled.

REJECTION OF APPLICATION

Rejection on what basis

Sub-section(5) The Reserve Bank may reject the application made under sub-section (2) if it is satisfied that the conditions specified in sub-section (3) are not fulfilled:

If the conditions set out in sub-section (2) of section 3 have been duly complied with, an application cannot be rejected, and the rejection of an application on grounds not germane to those as set out in sub-section (2) have not been fulfilled.

Opportunity of being heard

As per proviso to Sub-section (5) of section 3 before rejecting the application, the applicant shall be given a reasonable opportunity of being heard.

It means that the company must be told on what grounds, as statutorily required are not fulfilled.

The applying company must be given the opportunity to substantiate that the conditions as laid down under sub-section (2) have been duly complied with. It shall also be given opportunity to rebut the evidence or any other material brought on record against the applying company in support of the alleged non-fulfilment of one or other statutory condition.

Remedy against wrongful grant or wrongful rejection of certificate

The party can challenge decision of rejection of application in following cases

a) Before rejection of the application, the applying party was not given a reasonable opportunity of being heard.

b) The application has been rejected on grounds other than thoseset out in sub-section(2), that is, the rejection is based on extraneous grounds and ignoring to take into consideration relevant material.

c) The decision for rejection has not been supported by any reasons, ot the reasons given are not pertinent to facts that exist or to laws that applies.

Fresh application on rejection

Application for rejection can be made only on non fulfillment of conditions specified in sub-section (2) of Section 3. However the applying company can apply afresh for registration and there is no prohibition to that effect.

Any substantial change requires approval

Every securitisation company or reconstruction company, shall obtain prior approval of the Reserve Bank for any substantial change in its management or change of location of its registered office or change in its name

As per proviso the decision of Reserve Bank whether a change in management of a company is substantial or not is final.

Cancellation of Certificate of Registration by Reserve Bank

As per section 4

(1) The Reserve Bank may cancel a certificate of registration granted to a securitisation company or a reconstruction company, if such company--

(a) ceases to carry on the business of securitisation or asset reconstruction; or

(b) ceases to receive or hold any investment from a qualified institutional buyer; or

(c) has failed to comply with any conditions subject to which the certificate of registration has been granted to it; or

(d) at any time fails to fulfill any of the conditions referred to in clauses (a) to (g) of sub-section (3) of section 3; or

(e) fails to--

(i) comply with any direction issued by the Reserve Bank under the provisions of this Act; or

(ii) maintain accounts in accordance with the requirements of any law or any direction or order issued by the Reserve Bank under the provisions of this Act; or

(iii) submit or offer for inspection its books of account or other relevant documents when so demanded by the Reserve Bank; or

(iv) obtain prior approval of the Reserve Bank required under subsection(6) of section 3:

PROVIDED that before cancelling a certificate of registration on the ground that the securitisation company or reconstruction company has failed to comply with the provisions of clause (c) or has failed to fulfil any of the conditions referred to in

clause (d) or sub-clause (iv) of clause (e), the Reserve Bank, unless it is of the opinion that the
delay in cancelling the certificate of registration granted under subsection (4) of section 3 shall be prejudicial to the public interest or the interests of the investors or the securitisation company or the reconstruction company, shall give an opportunity to such company on such terms as the Reserve Bank may specify for taking necessary steps to comply with such provisions or fulfillment of such conditions.

(2) A securitisation company or reconstruction company aggrieved by the order of cancellation of certificate of registration may prefer an appeal, within a period of thirty days from the date on which such order of cancellation is communicated to it, to the Central Government:

PROVIDED that before rejecting an appeal such company shall be given a reasonable opportunity of being heard.

(3) A securitisation company or reconstruction company, which is holding investments of qualified institutional buyers and whose application for grant of certificate of registration has been rejected or certificate of registration has been cancelled shall, notwithstanding such rejection or cancellation, be deemed to be a securitisation company or reconstruction company until it repays the entire investments held by it (together with interest, if any) within such period as the Reserve Bank may direct.

(12) RISKS INVOLVED IN SECURITISATION BUSINESS

Securitization will be exposed to following types of Risks

1. Default Risk
2. Liquidity Risk
3. Prepayment Risk
4. Reputation Risk
5. Strategic Risk
6. Interest Rate Risk
7. Legal Risk

1. **Default Risk**

   Default risk is the risk that investors would suffer as a result of default of underlying borrower. The possibility that a borrower will be unable to meet interest and/or principal repayment obligations on a loan agreement. Default risk has a significant effect on the value of a asset if a borrower's ability to repay debt is impaired, default risk is higher and the value of the asset will decline.

2. **Liquidity Risk**

   Borrowers may not pay the monthly dues on due date. Two or more installments may be received at a same time. The delay in payout may result in erratic cash flows i.e cash flows in certain month may not match the liquidity available. Liquidity risks is the risk arising from mismatches in pay in and pay out schedules and not by default in repayment and credit losses. The extent of liquidity shortfall caused by default/ credit loss will have to be met from credit enhancement. Liquidity risk can be mitigated putting up cash collateral, liquidity advance, originators or third party guarantee

   Staggering Cash Flows

   Staggering pay out of Cash Flows is one of the means to minimize liquidity mismatch. Staggering means instead of passing on whole of months collection to investors spread the payout over two to four months. For example paying 70 percent of current moths inflow in current payout date, while 20 percent in next payout date and 10 percent in second next payout date.

3. **Prepayment Risk**

   It is a risk that obligor will pay out his dues before maturity date. It can be full prepayment of part prepayment. Prepayment brings in extra cash collection over and above the schedule. However some prepayment is modeled in the cash flows. Problem arises when prepayment rates vary from what is factored in. An increase in prepayment means principal portion of the pool comes back faster than anticipated. Full prepayment reduces the weighted average life of the pool but impact on weighted average maturity depends on the impact of the pool paid out.

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4. **Reputation Risk**

Reputation risk is the risk to earnings or capital arising from negative public opinion. This affects the institution's ability to establish new relationships or services or continue servicing existing relationships. This risk can expose the institution to litigation, financial loss, or damage to its reputation. Reputation risk is present throughout the organization and includes the responsibility to exercise an abundance of caution in dealing with its customers and community.

Nature of Reputation Risk

Exposure to reputation risk is essentially a function of how well the internal risk management process is working in each of the other risk categories and the manner and efficiency with which management responds to external influences on bank-related transactions. Reputation risk has a "qualitative" nature, reflecting the strength of an organization's franchise value and how it is perceived by other market participants. This perception is usually tied to performance over time. Although each role a bank plays in securitization places its reputation on the line, it stakes its reputation most heavily on the quality of the underlying receivables and the efficiency of its servicing orother fiduciary operations.

Asset performance that falls short of expectations will reflect poorly on the underwriting and risk assessment capabilities of the originator. Because the asset performance of securitized pools is publicly disclosed and monitored by market participants, securitization can highlight problems that were less obvious when reported as a smaller component of overall portfolio performance.

The best evidence of positive or negative perception is how the market accepts and prices newly issued asset-backed securities. Poorly performing assets or servicing errors on existing transactions can increase the costs and decrease the profitability of future deals. Reputation as an underwriter or servicer is particularly important to issuers that intend to securitize regularly.

For some issuers, negative publicity from securitization transactions may cause the market to avoid other liability as well as equity issuances.

Managing Reputation Risk

The most effective method of controlling reputation risk is a sound business plan and a comprehensive, effective risk management and control framework that covers all aspects of securitization activities. Up-front effort will minimize the potential for unexpected errors and surprises, most of which are quite visible to public market participants.

Management of reputation risk often involves business decisions that extend beyond the technical, legal, or contractual responsibilities of the bank. For securitization activities, problems are most often associated with revolving assets. Although the bank has transferred legal liability for performance of such receivables, it is nevertheless closely associated with the assets through servicing, through replacement receivables sales, or simply by name.

Decisions to protect franchise value by providing additional financial support should be made with full recognition of the potential long-term market, accounting, legal, and regulatory impacts and costs.

5. Strategic Risk

Strategic risk is the risk to earnings and capital arising from adverse business decisions or improper implementation of those decisions. This risk is a function of the compatibility of an organization's strategic goals, the business strategies developed to achieve those goals, the resources deployed against those goals, and the quality of implementation. The resources needed to carry out business strategies are both tangible and intangible. They include communication channels, operating systems, delivery networks, and managerial capacities and capabilities.

Nature of Strategic Risk

To assess a strategic risk exposure, one must recognize the long-term impacts of securitization on operations, profitability, and asset/liability management. Such exposure increases if transactions are undertaken without considering the long-term internal resource requirements. For example, while the existing systems in the credit and collections department may be adequate for normal operations, securitization transactions are often accompanied by rapid growth in the volume of transactions and more timely and precise reporting requirements. At a minimum this may require improved computer systems and software and dedicated operational and treasury personnel. Business and strategic plans should delineate the long- term resources needed to handle the projected volume of securitization.

Decisions on credit quality and origination also exposes to strategic risk. The availability of funding, the opportunity to leverage systems and technology, and the ability to substantially increase fee income through securitization should not lure issuers into a business line about which they don't have sufficient knowledge.

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6. Interest Rate Risk

A significant risk in securitization structure arises from changes in interest rates. Interest rates movement can affect securitization structure in following cases.

- Underlying asset are fixed rate while issued obligations are floating rate
  When the underlying
- Underlying assets are at floating rate while issued obligations are fixed rate
- Underlying assets and issued obligations are at floating rate but the floating benchmarks are different.

When the underlying assets are at floating rate and obligation are at fixed rate, fall in market interest rates reduces interest income though the interest payout remains the same. This reduces the spread available.

7. Legal Risk

a) Stamp Duty:

One of the biggest hurdles facing the development of the securitisation market is the stamp duty structure. Stamp duty is payable on any instrument which seeks to transfer rights or receivables, whether by way of assignment or novation (new clause added to the contract) or by any other mode. Therefore, the process of transfer of the receivables from the originator to the SPV involves an outlay on account of stamp duty, which can make securitisation commercially unviable in several states. If the securitised instrument is issued as evidencing indebtedness, it would be in the form of a debenture or bond subject to stamp duty. On the other hand, if the instrument is structured as a Pass Through Certificate (PTC) that merely evidences title to the receivables, then such an instrument would not attract stamp duty, as it is not an instrument provided for specifically in the charging provisions.

Among the regulatory costs, the stamp duty on transfers of the securitized instrument is again a major hurdle.

Some states do not distinguish between conveyances of real estate And that of receivables, and levy the same rate of stamp duty on the two. Stamp duty being a concurrent subject i.e. it is under the concurrent list in Schedule 7 of the Indian Constitution, specifically calls for a consensual legal position between the Centre and the States.

b) Foreclosure Laws

Lack of effective foreclosure laws also prohibits the growth of securitization in India. The Existing foreclosure laws are not lender friendly and increase the risks of Mortgage Backed Securities by making it difficult to transfer property in cases of default. Transfer of property laws lacks on this aspect.

c) Taxation related issues:

Tax treatment of Mortgage Backed Securities, SPV Trusts and NPL Trusts is unclear. Currently, the investors (PTC and SR holders) pay tax on the income distributed by the SPV Trusts and on that basis the trustees make income pay outs to the PTC holders without any payment or withholding of tax. The view is based on legal opinions regarding assessment of investors instead of trustee in their representative capacity. It needs to be emphasized that the Income Tax Law has always envisaged taxation of an Unincorporated SPV such as a Trust at only one level, either at the Trust SPV level, or the Investor/Beneficiary Level to avoid double taxation. Hence, any explicit tax pass thro regime if provided in the Income Tax Act does not represent conferment of any real tax concession or tax sacrifice, but merely represents a position that the Investors in the trust would be liable to tax instead of the Trust being held liable to tax on the income earned. Amendments need to be made to provide an explicit tax pass thought treatment to securitization SPVs and Non Performing Assets Securitization SPVs on par with the tax pass through treatment applied under the tax law to Venture Capital Funds registered with SEBI. To make it certain that investors as holders of Mutual Fund (MF) schemes are liable to pay tax on the income from MF and ensure that there is no tax dispute about the MBS SPV Trust or NPA Securitization Trust being treated as an AOP(Association of Persons), SEBI should consider the possibility of modifying the Mutual Fund Regulations to permit wholesale investors (investors who invests not less than Rs. 5 million in scheme) to invest and hold units of a closed-ended passively managed mutual fund scheme. The sole objective of this scheme is to invest its funds into PTCs and SRs of the designated Mortgage Backed Security.

d) SPV Trust and NPA Securitization Trust:

Recognizing the wholesale investor and Qualified Institutional Buyers (QIB) in securitization trusts, there should be no withholding of tax requirements on interest paid by the borrowers (whose credit exposures are securitized) to the securitization trust. Similarly, there should be no requirement of withholding tax on distributions made by the securitization Trust to its PTC and SR holders. However, the securitization trust may be required to file an annual return with the Income-tax Department, Ministry of Finance, in which all relevant particulars of the income distributions and identity of the PTC and SR holders may be included. This will safeguard against any possibility of revenue leakage.

e) Legal Issues:

Listing of PTCs on stock exchange:

Currently, the Securities Contract Regulation Act definition of 'securities' does not specifically cover PTCs. While there is indeed a legal view that the current definition of securities in the SCRA includes any instrument derived from, or any interest in securities, the nature of the instrument and the background of the issuer of the instrument, not being homogenous in respect of the rights and obligations attached, across instruments issued by various SPVs, has resulted in a degree of discomfort among exchanges listing these instruments. To remove any ambiguity in this regard, the Central Government should consider notifying PTCs and other securities issued by securitization SPV Trust as 'securities' under the SCRA.

Some issues under the SARFAESI Act: The ambiguity about whether or not Asset Reconstruction Companies (RECONSTRUCTION COMPANYs) and Securitization Companies (SCs) registered with the RBI can establish multiple SPV Trusts, has been resolved by a specific provision in the form of sec.7 (2A) of the SARFAESI Act. In view of this, it is now possible to unambiguously adopt the trust SPV structure even under the SARFAESI Act for MBS, ABS or NPL securitization.

The current definition of 'Security Receipt (SR)' envisages SR to be the evidence of acquisition by its holder of an undivided right, title or interest in the financial asset involved in securitization. This definition is appropriate and sufficient for securitization structures where securities issued are all characterized as 'Pass Through Securities'.

(13) ACCOUNTING ASPECTS OF SECURITISATION

The accounting treatment of a securitisation transaction is tedious, gruelling and back breaking process but nevertheless, there are various guidelines formulated by the ASB of the ICAI which are helpful in understanding the accounting process. Whenever we talk about the accounting treatment of securitisation transaction, we need to consider two aspects of it. They are:

Derecognition

The first activity is to derecognise the assets (which have been pooled for securitisation) from the balance sheet of the originator. To do this, we can consider the guidelines laid down by IAS 39 (AC 133) for transfer of risk and rewards as well as the extent of control of the asset.

Consolidation

The second aspect is whether the asset would have to be recognised on consolidation, even if the requirements for derecognition from the balance sheet of the originator have been met i.e. SIC 12 (AC 412) requires an SPV to be consolidated by the originator when the substance of the transaction indicates that the SPV is controlled by the originator. The extent of equity invested by the originator in the SPV is not conclusive in terms of deciding the extent of control.

Losing control over the securitised asset:

It is mandatory to derecognise a Securitised asset in the books of the Originator, if and only if, either by a single transaction or by a series of transactions taken as a whole, the Originator loses control of the contractual rights that comprise the securitised asset. It can be clearly without any ambiguity said that the Originator loses such control only if it surrenders the rights to benefits specified in the contract. Now in order to figure out whether the Originator has lost control of the securitised asset depends both on the Originator's position and that of the SPV. It should be noted however, that if the position of either the Originator or the SPV indicates that the Originator has retained control, the Originator should not remove the securitised asset from its balance sheet.

Whether the Originator has lost control over the securitised asset should be determined on the basis of the facts and circumstances of the case by considering all the evidence available. However, one cannot construe that the Originator has not lost control over the securitised asset because of the following reasons:

a. The Originator continues to service the securitised asset. Such servicing by itself would not lead to a conclusion that the Originator has not lost control over the securitised asset.

b. An obligation is cast on the Originator to repurchase the securitised asset at a predetermined price. Such an obligation is not an entitlement to reassume ownership available to the Originator. Notwithstanding such an obligation the securitised asset would be beyond the control of the Originator. The obligation accepted by the Originator should be accounted for in the manner indicated in the subsequent paragraphs. However, where the Originator is both entitled and obligated to repurchase the securitised asset at a pre-determined price, the Originator is not considered to have lost control over the securitised asset and, therefore, the same should not be removed from the balance sheet of the Originator.

On derecognition, the difference between the book value of the securitised asset and consideration received should be treated as gain or loss arising on securitisation and disclosed separately in the statement of profit and loss. On the other hand, if the derecognition criterion as prescribed in the above paragraph is not met, the asset should continue to be recognised in the books of the Originator and consideration received for the asset so transferred, should be accounted for as a borrowing secured there against.

What happens when the consideration received in other than cash?

If the consideration is received in a form other than cash, e.g., securities issued by the SPV, should be measured at the lowest of the

a. the fair value of the consideration;

b. the net book value of the securitised assets; and
the net realisable value of the securitised assets.

What happens when the consideration received in other than cash?

In case the consideration has been received partly in cash and partly in a form other than cash, the non-cash component of the consideration should be measured at the lowest of the

a. the fair value of the non-cash component;

b. the net book value of the securitised assets as reduced by the cash received; and

c. the net realisable value of the securitised assets as reduced by the cash received.

The fair value is the price that would be agreed upon between knowledgeable, willing parties in an arm's length transaction. Quoted market price in an active, liquid and freely accessible market, if available, is normally the best evidence of fair value. If quoted market price is not available, estimate of fair value may be based on the market prices of assets similar to those received as consideration. In case the market prices of similar assets are also not available, the estimate of fair value may be based on generally accepted valuation techniques such as the present value of estimated future cash flows. These techniques would require estimates and assumptions about various matters such as estimates of future revenues, future expenses and assumptions about interest rates, defaults and likely prepayments. Some of these estimations, e.g., estimation of future cash flows and discount rates may present significant difficulties. It would be necessary to make the best estimate based on reasonable and supportable assumptions and projections. All available evidence should be considered in developing the requisite estimate and assumptions.

What happens if the securitised assets do not qualify for derecognition?

In case the securitised assets qualify for derecognition, the entire expenses incurred on the transaction, say, legal fees, etc., should be expensed at the time of the transaction and should not be deferred. Where the securitised assets do not qualify for derecognition and, therefore, the consideration received in respect thereof is treated as a secured borrowing, such expenses should either be amortised over the term of the secured borrowing or recognised immediately in the statement of profit and loss.

If a securitised asset qualifies to be derecognised as per the above paragraph and the Originator has accepted recourse or similar obligation, e.g., the Originator has granted a Put Option at a predetermined price to the SPE, then the contingent loss arising therefrom, should be accounted for as per Accounting Standard (AS) 4, 'Contingencies and Events Occurring After the Balance Sheet Date', issued by the Institute of Chartered Accountants of India. This would require that a provision be made for the contingent loss arising from the obligation, where the criteria specified in the Standard in this regard are satisfied.

Future Receivables / Revolving Securitisation

Any purchase consideration received by the Originator on the securitisation of future receivables should be accounted for as an advance, since the assets proposed to be securitised would not be existing at the time of the agreement, but would arise in future. The cost of bringing these assets into existence would also be incurred in future. In such cases, the criterion for derecognition prescribed in the above paragraph should be applied as and when the relevant assets come into existence. Till such time the amounts received, if any, on account of the proposed securitisation should be reflected as an advance. The other requirements of the Guidance Note on Accounting of Securitisation also apply, mutatis mutandis, in case of securitisation of future receivables.

In case of revolving period securitisation where financial assets are transferred as and when they come into existence or at specified intervals and the purchase consideration is paid to the Originator at the time of such transfer, all requirements of this Guidance Note, except the above paragraph, apply.

Partial Derecognition

An Originator may transfer only a part of the financial asset in a securitisation transaction instead of transferring the complete asset. Such transfer may occur in two ways. One way is where a proportionate share of the asset is transferred. For example, the Originator may transfer a proportionate share of loan (including right to receive both interest and principal), in such a way that all future cash flows, profit/loss arising on loan will be shared by the Originator and the SPE in fixed proportions. A second way of transferring a part of a financial asset arises where the asset comprises the rights to two or more benefit streams, and the Originator transfers one or more of such benefit streams while retaining the others. For example, the Originator may securitise the Principal Strip of the loan while retaining the Interest Strip and Servicing Asset.

If the Originator transfers a part of a financial asset while retaining the other part, the part of the original asset which meets the derecognition criterion as set out in the above paragraph should be derecognised whereas the remaining part should continue to be recognised in the books. Similarly, if any new interest has been created as a result of securitisation transaction, such as a Call Option, the new interest should be recognised in the books in accordance with the relevant accounting principles.

If the Originator transfers a proportionate part of the asset, the previous carrying amount of the asset is apportioned among the part transferred and the part retained on the basis of proportion transferred and proportion retained. For example, if the originator transfers 75% of an asset to the SPV, 75% of the carrying amount of the asset should be considered as securitised. Where the securitised part of the asset qualifies to be derecognised as per the requirements of the above paragraph , the entity would continue to recognise the remaining part of the asset at 25% of the carrying amount.

In case the asset comprises the rights to two or more benefit streams and one or more of such benefit streams is/are transferred while retaining the others, the carrying amount of such financial asset should be apportioned between the part(s) transferred and the part(s) retained on the basis of their relative fair values as on the date of transfer. The fair values of the parts should be determined on the basis described in paragraph 8. If fair value of the part of the asset that is retained cannot be measured reliably, that part should be valued at a nominal value of Re.1. Similarly, if any new financial asset, e.g., a call option, has been created as a result of securitisation transaction and its fair value cannot be measured reliably, initial carrying amount of the asset should be recognised at a nominal value of Re.1.

An example illustrating the computations and accounting treatment in case of partial derecognition is given below:

Illustration of Computation and Accounting in Case of Partial Derecognition

1. Suppose Company 'ABC' holds Rs. 1,000/- of loans yielding interest @ 18% p.a. for their estimated lives of nine years. Considering the interest rate the fair value of these loans is estimated at Rs. 1,100/-. The company securitises the principal component of the loan plus the right to receive interest @ 14% to an SPV for Rs. 1,000/-. Out of the balance interest of 4%, it is stipulated that half of such balance interest, namely 2%, will be due to the company as fees for continuing to service the loans. The fair value of the servicing asset so created is estimated, after taking into account the costs likely to be incurred in servicing the loan, at Rs. 40. The remaining half of the interest is due to the company as an interest strip receivable, the fair value of which is estimated at Rs. 60.

2. Since the company has securitised the principal and a part of the interest, it is

necessary to compute the cost attributable to various components assuming that the securitised components meet the derecognition criteria. This computation can be done by apportioning the carrying amount of the asset in the ratio of fair values as follows:

Fair Value of securitised component of the loan

	Rs.	Rs.
Fair value of loan		1,100
Less: Fair value of servicing asset	40	
Fair value of interest strip	60	100
Fair value of securitised component of loan		1,000

Apportionment of carrying amount based on relative fair values

Particulars	**Fair Values**	**%age based on Total Fair Value**	**Carrying Amount / Cost**
Securitised component of loan	1000	91	910
Servicing Asset	40	3.6	36
Interest Strip Receivable	60	5.4	54
	1,100	100	1,000

3. The profit arising on securitisation should be computed as follows:

	Rs.
Net proceeds of securitisation	1,000
Less: Cost (apportioned carrying amount) of securitised	910

component of loan

Profit on securitisation		90	

4. Based on the above, the following journal entries would be passed in the books of the Originator:

		Rs.	Rs.
(a) To record securitisation of principal plus right to 14% interest			
Cash A/c	Dr.	1,000	
To Loans A/c (cost of securitised component)			910
To Profit on Securitisation			90
(b) To record the creation of servicing asset and interest strip receivable			
Servicing asset A/c	Dr.	36	
Interest strip A/c	Dr.	54	
To Loans A/c			90

Accounting in the Books of Special Purpose Vehicle

The SPV should recognise the asset received under a securitisation transaction, if the Originator loses control over the securitised asset on the basis of the criterion prescribed in the above paragraph. The asset so received should be recognised at the amount of consideration, if the consideration has been paid in cash. In case the consideration has been paid in a form other than cash, e.g., securities, the asset so received should be recorded either at its intrinsic value or at the fair value of the consideration, whichever is more clearly evident. If both the values are equally evident the asset should be valued at the lower of the two values.

If the beneficial ownership in the securitised asset has not been transferred to the SPV or the Originator has not lost control over the asset as per the requirements of the above paragraph on derecognition, the SPV should not recognise the asset received. In such a case, the consideration paid should be recorded as a lending secured against the financial asset received under securitisation transaction.

The amount received by the SPv on issue of PTCs or other securities should be shown on the liability side of the balance sheet, with appropriate description, keeping in view the nature of securities issued.

Accounting in the Books of the Investor

The Investor should account for the PTCs and/or debt securities acquired by it as an investment in accordance with Accounting Standard (AS) 13, 'Accounting for Investments'. However, where in case of an Investor, AS 13 is not applicable because of the Investor being specifically exempted from the application of AS 13, the investments in PTCs and/or other securities should be valued and accounted for as per the relevant accounting principles applicable to the Investor.

Disclosures

In addition to the disclosures arising from recommendations made in the above paragraph on recourse by the Originator, the following disclosures should be made in the financial statements of the Originator:

i. The nature and extent of securitisation transaction(s), including the financial assets that have been derecognised.

ii. The nature and the amounts of the new interests created, if any.

iii. Basis of determination of fair values, wherever applicable.

The following disclosures should be made in the financial statements of the SPV:

i. The nature of the securitisation transaction(s) including, in particular, a description of the rights of the SPE vis-à-vis the Originator whether arising from the securitisation transaction or a transaction associated therewith.

ii. Basis of determination of fair values, wherever applicable.

The Investor should make disclosure of investments in PTCs and/or debt securities as required by Accounting Standard (AS) 13, 'Accounting for Investments'. However, where in the case of an Investor, AS 13 is not applicable because the Investor is specifically exempted from the application of AS 13, the Investor should make such disclosures as per the relevant requirements.

Accounting Standards:

Accounting Standards are the statements of code of practice of the regulatory accounting bodies that are to be observed in the preparation and presentation of financial statements. In layman terms, accounting standards are the written documents issued by the expert institutes or other regulatory bodies covering various aspects of measurement, treatment, presentation and disclosure of accounting transactions.

Objectives of Accounting Standards

The basic objective of Accounting Standards is to remove variations in the treatment of several accounting aspects and to bring about standardization in presentation. They intent to harmonize the diverse accounting policies followed in the preparation and presentation of financial statements by different reporting enterprises so as to facilitate intra-firm and inter-firm comparison.

Who issues Accounting Standards in India?

Indian Accounting Standards, (abbreviated as india AS) are a set of accounting standards notified by the Ministry of Corporate Affairs which are converged with International Financial Reporting Standards (IFRS). These accounting standards are formulated by Accounting Standards Board of Institute of Chartered Accountants of India. Now India will have two sets of accounting standards viz. existing accounting standards under Companies (Accounting Standard) Rules, 2006 and IFRS converged Indian Accounting Standards(Ind AS). The Ind AS are named and numbered in the same way as the corresponding IFRS. NACAS recommend these standards to the Ministry of Corporate Affairs. The Ministry of Corporate Affairs has to spell out the accounting standards applicable for companies in India. As on date the Ministry of Corporate Affairs notified 35 Indian Accounting Standards(Ind AS). But it has not notified the date of implementation of the same.

As of now, the following Accounting Standards formulated by the ICAI are applicable with respect to Securitisation transactions:

1. AS 4- Contingencies and events occurring after the balance sheet date
2. AS 30- Financial Instruments: Recognition and Measurement
3. AS 31- Financial Instruments: Presentation
4. AS 32- Financial Instruments: Disclosures

Accounting Standard 4: Contingencies and Events Occurring after the Balance Sheet Date

- A contingency is a condition or situation the ultimate outcome of which will be known or determined only on the occurrence or non-occurrence of uncertain future event/s.
- Events occurring after the balance sheet date are those significant events both favourable and unfavourable that occur between the balance sheet date and the date on which the financial statements are approved.
- Amount of a contingent loss should be provided for by a charge in P & L A/c if it is probable that future events will confirm that an asset has been impaired or a liability has been incurred as at the balance sheet date and a reasonable estimate of the amount of the loss can be made.
- Existence of contingent loss should be disclosed if above conditions are not met, unless the possibility of loss is remote.
- Contingent Gains if any, not to be recognised in the financial statements.

- Material change in the position due to subsequent events be accounted or disclosed.
- Proposed or declared dividend for the period should be adjusted.
- Material event occurring after balance sheet date affecting the going concern assumption and financial position be appropriately dealt with in the accounts.
- Contingencies or events occurring after the balance sheet date and the estimate of the financial effect of the same should be disclosed.

Accounting Standard 30: Financial Instruments: Recognition and Measurement

Introduction

AS 30 Financial Instruments: Recognition and Measurement comes into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years. This Accounting Standard will become mandatory in respect of accounting periods commencing on or after 1-4-2011 for all commercial, industrial and business entities except to a Small and Medium-sized Entity.

AS 30 prescribes principles for recognising and measuring all types of financial instruments except:

a. those interests in subsidiaries, associates and joint ventures that are accounted for under AS 21, AS 23 or AS 27

b. rights and obligations under leases to which AS 19 applies. however:

i. lease receivables recognised by a lessor are subject to the derecognition and impairment provisions of this standard;

ii. finance lease payables recognised by a lessee are subject to the derecognition provisions of this standard; and

iii. derivatives that are embedded in leases are subject to the embedded derivatives provisions of this standard

c. employers' rights and obligations under employee benefit plans to which AS 15 applies

d. financial instruments issued by the entity that meet the definition of an equity instrument in AS 31 (including options and warrants) However, the holder of such equity instruments should apply this Standard to those instruments, unless they meet the exception in (a) above

e. rights and obligations under insurance contracts which will be covered by proposed Accounting Standard on Insurance Contract, a contract that is within the scope of Accounting Standard on Insurance Contracts because it contains a discretionary participation feature. However, AS 30 applies to derivatives embedded in such a contract;

f. contracts for contingent consideration in a business combination. This exemption applies only to the acquirer.

g. contracts between an acquirer and a vendor in a business combination to buy or sell an acquiree at a future date;

h. loan commitments other than those that are designated as financial liabilities at fair value through profit or loss. An issuer of loan commitments should apply AS 29 to those loan commitments that are not within the scope of this standard However, all loan commitments are subject to the derecognition provisions of this Standard

i. financial instruments, contracts and obligations under share-based payment transactions, except certain contracts to buy or sell a non-financial item as noted below:

1. Contracts means those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments. However, AS 30 does not apply to any such contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements
2. Contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments.
3. A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments
4. Paragraphs 68, 69 and 70 of this Standard, which should be applied to treasury shares, purchased, sold, issued or cancelled in connection with employee share option plans, employees share purchase plans, and all other share-based payment arrangements

Recognition and derecognition

A financial asset or liability is recognised when the entity becomes a party to the instrument contract. A financial liability is derecognised when the liability is extinguished. A financial asset is derecognised when, and only when:

a. The contractual rights to the cash flows from the asset expire; or
b. The entity transfers substantially all the risks and rewards of ownership of the asset; or

c. The entity transfers the asset, while retaining some of the risks and rewards of ownership, but no longer has control of the asset (i.e., the transferee has the ability to sell the asset). The risks and rewards retained are recognised as an asset.

Measurement

Financial assets and liabilities are initially recognised at fair value. Subsequent measurement depends on how the financial instrument is categorised:

At amortised cost using the effective interest method

a. **Held-to-maturity investments:** Non-derivative financial assets with fixed or determinable payments and maturity that the entity has the positive intention and ability to hold to maturity.

b. **Loans and receivables:** Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market.

c. Financial liabilities that are not held for trading and not designated at fair value through profit or loss.

At fair value

At fair value through profit or loss: Financial asset or liability that is classified as held for trading, is a derivative or has been designated by the entity at inception as at fair value through profit or loss.

Available-for-sale financial assets: Non-derivative financial assets that do not fall within any of the other categories. The unrealised movements in fair value are recognised in equity until disposal or sale, at which time, those unrealised movements from prior periods are recognised in profit or loss.

If there is objective evidence that a financial asset is impaired, the carrying amount of the asset is reduced and impairment loss is recognised. A financial asset carried at amortised cost is not carried at more than the present value of estimated future cash flows. An impairment loss on an available-for-sale asset that reduces the carrying amount below acquisition cost is recognised in profit or loss.

Hedge accounting

AS 30 provides for two kinds of hedge accounting, recognising that entities commonly hedge both the possibility of changes in cash flows;(i.e., a cash flow hedge) and the possibility of changes in fair value(i.e., a fair value hedge). Strict conditions must be met before hedge accounting is applied:

- There is formal designation and documentation of a hedge at inception.
- The hedge is expected to be highly effective (i.e., the hedging instrument is expected to almost fully offset changes in fair value or cash flows of the hedged item that are attributable to the hedged risk).
- Any forecast transaction being hedged is highly probable.
- Hedge effectiveness is reliably measurable (i.e., the fair value or cash flows of the hedged item and the fair value of the hedging instrument can be reliably measured).
- The hedge must be assessed on an ongoing basis and be highly effective.

When a fair value hedge exists, the fair value movements on the hedging instrument and the corresponding fair value movements on the hedged item are recognised in profit or loss. When a cash flow hedge exists, the fair value movements, on the part of the hedging instrument that is effective, are recognised in equity until such time as the hedged item affects profit or loss. Any ineffective portion of the fair value movement on the hedging instrument is recognised in profit or loss.

Embedded derivatives

AS 30 requires derivatives that are embedded in non-derivative contracts to be accounted for separately at fair value through profit or loss.

Accounting Standard 31: Financial Instruments: Presentation

This Standard comes into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years. This Accounting Standard will become mandatory in respect of accounting periods commencing on or after 1-4-2011 for all commercial, industrial and business entities except to a Small and Medium-sized Entity.

This Standard should be applied by all entities to all types of financial instruments except:

a. accounted for in accordance with AS 21, AS 23, AS 27 However, in some cases, AS 21, AS 23 or AS 27 permits or requires an entity to account for an interest in a subsidiary, associate or joint venture using AS 30, in those cases, entities should apply the disclosure requirements in AS 21, AS 23 or AS 27 in addition to those in this Standard. Entities should also apply this Standard to all derivatives linked to interests in subsidiaries, associates or joint ventures.

b. Employers' rights and obligations under employee benefit plans, to which AS 15, Employee Benefits, applies.

c. Contracts for contingent consideration in a business combination. This exemption applies only to the acquirer. The term 'Business combination' means the bringing together of separate entities or businesses into one reporting entity. At present, AS 14, deals with accounting for contingent consideration in an amalgamation, which is a form of business combination.

d. Rights and obligations under insurance contracts which will be covered by proposed Accounting Standard on Insurance Contract, a contract that is within the scope of Accounting Standard on Insurance Contracts because it contains a discretionary participation feature. However, AS 30 applies to derivatives embedded in such a contract;

e. Contracts with discretionary clause

Financial instruments, contracts and obligations under share-based payment transactions, except certain contracts to buy or sell a non-financial item as noted below:

1. Contracts those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments. However, AS 30 does not apply to any such contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements

2. Contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments.

3. A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments

4. Paragraphs 68, 69 and 70 of this Standard, which should be applied to treasury shares, purchased, sold, issued or cancelled in connection with employee share option plans, employees share purchase plans, and all other share-based payment arrangements

AS 31 applies to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments. However, AS 30 does not apply to any such contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

Financial instruments are classified, from the perspective of the issuer, as financial assets, financial liabilities and equity instruments. Compound financial instruments may contain both a liability and an equity component.

Interests, dividends, losses and gains relating to financial liabilities are recognized as income or expense in profit or loss. Distributions to holders of equity instruments are debited directly to equity, net of any related income tax benefit.

Financial assets and financial liabilities are offset when and only when there is a legally enforceable right to set off and the entity intend to settle on a net basis.

AS 31 requires disclosure about factors that affect the amount, timing and certainty of an entity's future cash flows relating to financial instruments and the accounting policies applied to those instruments. It also requires disclosure about the nature and extent of an entity's use of financial instruments, the business purposes they serve, the risks associated with them, and management's policies for controlling those risks.

The principles in AS 31 complement the principles for recognizing and measuring financial assets and financial liabilities as given in AS 30.

Accounting Standard (AS) 32 Financial Instruments: Disclosures

Accounting Standard (AS) 32, Financial Instruments: Disclosures, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years. This Accounting Standard will become mandatory in respect of accounting periods commencing on or after 1-4-2011 for all commercial, industrial and business entities except to a Small and Medium-sized Entity, as defined below:

(i) Whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(ii) which is not a bank (including a co-operative bank), financial institution or any entity carrying on insurance business;

(iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

(iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

(v) which is not a holding or subsidiary entity of an entity which is not a small and medium-sized entity.

For the above purpose an entity would qualify as a Small and Medium-sized Entity, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

Where in respect of an entity there is a statutory requirement for disclosing any financial instrument in a particular manner as asset, liability or equity and/or for disclosing income, expenses, gains or losses relating to a financial instrument in a particular manner as income/expense or as distribution of profits, the entity should disclose that instrument and/or income, expenses, gains or losses relating to the instrument in accordance with the requirements of the statute governing the entity. Until the relevant statute is amended, the entity disclosing that instrument and/ or income, expenses, gains or losses relating to the instrument in accordance with the requirements thereof will be considered to be complying with this Accounting Standard, in view of paragraph 4.1 of the Preface to the Statements of Accounting Standards which recognises that where a requirement of an Accounting Standard is different from the applicable law, the law prevails.

Objective Accounting Standard (AS) 32 Financial Instruments Disclosures

1. The objective of this Standard is to require entities to provide disclosures in their financial statements that enable users to evaluate:

   (a) the significance of financial instruments for the entity's financial position and performance; and

   (b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

2. The principles in this Accounting Standard complement the principles for recognising, measuring and presenting financial assets and financial liabilities in Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement and Accounting Standard (AS) 31, Financial Instruments: Presentation.

Scope of Accounting Standard (AS) 32 Financial Instruments Disclosures

3. This Accounting Standard should be applied by all entities to all types of financial instruments, except:

   (a) those interests in subsidiaries, associates and joint ventures that are accounted for in accordance with AS 21, Consolidated Financial Statements and Accounting for Investment in Subsidiaries in Separate Financial Statements, AS 23, Accounting for Investments in Associates, or AS 27, Financial Reporting of Interests in Joint Ventures. However, in some cases, AS 21, AS 23 or AS 27 permits or requires an entity to account for an interest in a subsidiary, associate or joint venture using Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement; in those cases, entities should apply the disclosure requirements in AS 21, AS 23 or AS 27 in addition to those in this Accounting Standard. Entities should also apply this Accounting Standard to all derivatives linked to interests in subsidiaries, associates or joint ventures unless the derivative meets the definition of an equity instrument in AS 31.

(b) employers' rights and obligations arising from employee benefit plans, to which AS 15, Employee Benefits, applies.

(c) contracts for contingent consideration in a business combination4. This exemption applies only to the acquirer.

(d) insurance contracts as defined in Accounting Standard on Insurance Contracts. However, this Accounting Standard applies to derivatives that are embedded in insurance contracts if Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement, requires the entity to account for them separately. Moreover, an issuer should apply this Accounting Standard to financial guarantee contracts if the issuer applies AS 30 in recognising and measuring the contracts, but should apply the Accounting Standard on Insurance Contracts if the issuer elects, in accordance with the Accounting Standard on Insurance Contracts, to apply that Accounting Standard in recognising and measuring them.

(e) financial instruments, contracts and obligations under share-based payment transactions except that this Accounting Standard applies to contracts within the scope of paragraphs 4 to 6 of AS 30.

4. This Accounting Standard applies to recognised and unrecognised financial instruments. Recognised financial instruments include financial assets and financial liabilities that are within the scope of AS 30. Unrecognised financial instruments include some financial instruments that, although outside the scope of AS 30, are within the scope of this Accounting Standard (such as some loan commitments).

5. This Accounting Standard applies to contracts to buy or sell a non-financial item that are within the scope of AS 30 (see paragraphs 4-6 of AS 30).

Classes of financial instruments and level of disclosure

6. When this Accounting Standard requires disclosures by class of financial instrument, an entity should group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those

financial instruments. An entity should provide sufficient information to permit reconciliation to the line items presented in the balance sheet.

Significance of financial instruments for financial position and performance of Accounting Standard (AS) 32 Financial Instruments Disclosures

7. An entity should disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.

Balance sheet

Categories of financial assets and financial liabilities

8. The carrying amounts of each of the following categories, as defined in AS 30, should be disclosed either on the face of the balance sheet or in the notes:

(a) financial assets at fair value through profit or loss, showing separately

(i) those designated as such upon initial recognition and

(ii) those classified as held for trading in accordance with AS 30;

(b) held-to-maturity investments;

(c) loans and receivables;

(d) available-for-sale financial assets;

(e) financial liabilities at fair value through profit or loss, showing separately

(i) those designated as such upon initial recognition and

(ii) those classified as held for trading in accordance with AS 30; and

(f) financial liabilities measured at amortised cost.

Financial assets or financial liabilities at fair value through profit or loss

9. If the entity has designated a loan or receivable (or group of loans or receivables) as at fair value through profit or loss, it should disclose:

(a) the maximum exposure to credit risk (see paragraph 36(a)) of the loan or receivable (or group of loans or receivables) at the reporting date.

(b) the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk.

(c) the amount of change, during the period and cumulatively, in the fair value of the loan or receivable (or group of loans or receivables) that is attributable to changes in the credit risk of the financial asset determined either:

(i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or

(ii) using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.

Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate or index of prices or rates.

(d) the amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the loan or receivable was designated.

10. If the entity has designated a financial liability as at fair value through profit or loss in accordance with paragraph 8.2 of AS 30, it should disclose:

(a) the amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability determined either:

(i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk (See Appendix B, paragraph B4); or

(ii) using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the liability.

Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates. For contracts that include a unit-linking feature, changes in market conditions include changes in the performance of the related internal or external investment fund.

(b) the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

11. The entity should disclose:

(a) the methods used to comply with the requirements in paragraphs 9(c) and 10(a).

(b) if the entity believes that the disclosure it has given to comply with the requirements in paragraph 9(c) or 10(a) does not faithfully represent the change in the fair value of the financial asset or financial liability attributable to changes in its credit risk, the reasons for reaching this conclusion and the factors it believes are relevant.

Reclassification of Accounting Standard (AS) 32 Financial Instruments Disclosures

12. If the entity has reclassified a financial asset as one measured:

(a) at cost or amortised cost, rather than at fair value; or

(b) at fair value, rather than at cost or amortised cost, it should disclose the amount reclassified into and out of each category and the reason for that reclassification (see paragraphs 57-60 of AS 30).

Derecognition of Accounting Standard (AS) 32 Financial Instruments Disclosures

13. An entity may have transferred financial assets in such a way that part or all of the financial assets do not qualify for derecognition (see paragraphs 15-37 of AS 30). The entity should disclose for each class of such financial assets:

(a) the nature of the assets;

(b) the nature of the risks and rewards of ownership to which the entity remains exposed;

(c) when the entity continues to recognise all of the assets, the carrying amounts of the assets and of the associated liabilities; and

(d) when the entity continues to recognise the assets to the extent of its continuing involvement, the total carrying amount of the original assets, the amount of the assets that the entity continues to recognise, and the carrying amount of the associated liabilities.

Collateral of Accounting Standard (AS) 32 Financial Instruments Disclosures

14. An entity should disclose:

(a) the carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with paragraphs 37(a) of AS 30; and

(b) the terms and conditions relating to its pledge.

15. When an entity holds collateral (of financial or non-financial assets) and is permitted to sell or repledge the collateral in the absence of default by the owner of the collateral, it should disclose:

(a) the fair value of the collateral held;

(b) the fair value of any such collateral sold or repledged, and whether the entity has an obligation to return it; and

(c) the terms and conditions associated with its use of the collateral.

Allowance account for credit losses of Accounting Standard (AS) 32 Financial Instruments Disclosures

16. When financial assets are impaired by credit losses and the entity records the impairment in a separate account (eg an allowance account used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying amount of the asset, it should disclose a reconciliation of changes in that account during the period for each class of financial assets.

International Accounting Standards/ International Financial Reporting Standards:

Accounting standards issued by the IASB (International Accounting Standards Board) are known as International Accounting Standards. Companies that are locally listed, as well as those that are not, are under obligation to use their financial statements in the countries that have accepted those standards.

A series of accounting standards, known as the International Accounting Standards, were released by the IASC between 1973 and 2000, and were ordered numerically. The series started with IAS 1, and concluded with the IAS 41, in December 2000. At the time when the IASB was established, they agreed to adopt the set of standards that were issued by the IASC, i.e. the IAS 1 to 41, but that any standards to be published after that would follow a series known as the International Financial Reporting Standards (IFRS).

IAS vs IFRS:

IAS stands for International Accounting Standards, while IFRS refers to International Financial Reporting Standards.

IAS standards were published between 1973 and 2001, while IFRS standards were published from 2001 onwards.

IAS standards were issued by the IASC, while the IFRS are issued by the IASB, which succeeded the IASC.

Principles of the IFRS take precedence if there's contradiction with those of the IAS, and this results in the IAS principles being dropped.

IAS 39 — Financial Instruments: Recognition and Measurement

IAS 39 *Financial Instruments: Recognition and Measurement* outlines the requirements for the recognition and measurement of financial assets, financial liabilities, and some contracts to buy or sell non-financial items. Financial instruments are initially recognised when an entity becomes a party to the contractual provisions of the instrument, and are classified into various categories depending upon the type of instrument, which then determines the subsequent measurement of the instrument (typically amortised cost or fair value). Special rules apply to embedded derivatives and hedging instruments.

IAS 39 was reissued in December 2003, applies to annual periods beginning on or after 1 January 2005, and will be superseded by IFRS 9 *Financial Instruments* once a mandatory application date of that standard is determined.

19 November 2013	IFRS 9 *Financial Instruments (Hedge Accounting and amendments to IFRS 9, IFRS 7 and IAS 39)* issued, permitting an entity to elect to continue to apply the hedge accounting requirements in IAS 39 for a fair value hedge of the interest rate exposure of a portion of a portfolio of financial assets or financial liabilities when IFRS 9 is applied, and to extend the fair value option to certain contracts that meet the 'own use' scope exception	Applies when IFRS 9 is applied*

* The release of IFRS 9 *Financial Instruments* (2013) on 19 November 2013 contained no stated effective date and contained consequential amendments which removed the mandatory effective date of IFRS 9 (2010) and IFRS 9 (2009), leaving the effective date open but leaving each standard available for application. Accordingly, these amendments apply when IFRS 9 is applied.

Scope exclusions

IAS 39 applies to all types of financial instruments except for the following, which are scoped out of IAS 39: [IAS 39.2]

- interests in subsidiaries, associates, and joint ventures accounted for under IAS 27 *Consolidated and Separate Financial Statements*, IAS 28 *Investments in Associates*, or IAS 31 *Interests in Joint Ventures* (or, for periods beginning on or after 1 January 2013, IFRS 10 *Consolidated Financial Statements*, IAS 27 *Separate Financial Statements* or IAS 28 *Investments in Associates and Joint Ventures*); however IAS 39 applies in cases where under those standards such interests are to be accounted for under IAS 39. The standard also applies to most derivatives on an interest in a subsidiary, associate, or joint venture
- employers' rights and obligations under employee benefit plans to which IAS 19 *Employee Benefits* applies
- forward contracts between an acquirer and selling shareholder to buy or sell an acquiree that will result in a business combination at a future acquisition date
- rights and obligations under insurance contracts, except IAS 39 does apply to financial instruments that take the form of an insurance (or reinsurance) contract but that

principally involve the transfer of financial risks and derivatives embedded in insurance contracts

- financial instruments that meet the definition of own equity under IAS 32 *Financial Instruments: Presentation*
- financial instruments, contracts and obligations under share-based payment transactions to which IFRS 2 *Share-based Payment* applies
- rights to reimbursement payments to which IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* applies

Leases

IAS 39 applies to lease receivables and payables only in limited respects: [IAS 39.2(b)]

- IAS 39 applies to lease receivables with respect to the derecognition and impairment provisions
- IAS 39 applies to lease payables with respect to the derecognition provisions
- IAS 39 applies to derivatives embedded in leases.

Financial guarantees

IAS 39 applies to financial guarantee contracts issued. However, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either IAS 39 or IFRS 4 *Insurance Contracts* to such financial guarantee contracts. The issuer may make that election contract by contract, but the election for each contract is irrevocable.

Accounting by the holder is excluded from the scope of IAS 39 and IFRS 4 (unless the contract is a reinsurance contract). Therefore, paragraphs 10-12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* apply. Those paragraphs specify criteria to use in developing an accounting policy if no IFRS applies specifically to an item.

Loan commitments

Loan commitments are outside the scope of IAS 39 if they cannot be settled net in cash or another financial instrument, they are not designated as financial liabilities at fair value through profit or loss, and the entity does not have a past practice of selling the loans that resulted from the commitment shortly after origination. An issuer of a commitment to provide a loan at a below-market interest rate is required initially to recognise the commitment at its fair value; subsequently, the issuer will remeasure it at the higher of (a) the amount recognised under IAS 37 and (b) the amount initially recognised less, where appropriate, cumulative amortisation recognised in accordance with IAS 18. An issuer of loan commitments must apply IAS 37 to other loan commitments that are not within the scope of IAS 39 (that is, those made at market or above). Loan commitments are subject to the derecognition provisions of IAS 39. [IAS 39.4]

Contracts to buy or sell financial items

Contracts to buy or sell financial items are always within the scope of IAS 39 (unless one of the other exceptions applies).

Contracts to buy or sell non-financial items

Contracts to buy or sell non-financial items are within the scope of IAS 39 if they can be settled net in cash or another financial asset and are not entered into and held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale, or usage requirements. Contracts to buy or sell non-financial items are inside the scope if net settlement occurs. The following situations constitute net settlement: [IAS 39.5-6]

- the terms of the contract permit either counterparty to settle net
- there is a past practice of net settling similar contracts
- there is a past practice, for similar contracts, of taking delivery of the underlying and selling it within a short period after delivery to generate a profit from short-term fluctuations in price, or from a dealer's margin, or
- the non-financial item is readily convertible to cash

Weather derivatives

Although contracts requiring payment based on climatic or geological, or other physical variable were generally excluded from the original version of IAS 39, they were added to the scope of the revised IAS 39 in December 2003 if they are not in the scope of IFRS 4. [IAS 39.AG1]

Definitions

IAS 39 incorporates the definitions of the following items from IAS 32 *Financial Instruments: Presentation*: [IAS 39.8]

- financial instrument
- financial asset
- financial liability
- equity instrument.

Note: Where an entity applies IFRS 9 *Financial Instruments* prior to its mandatory application date (1 January 2015), definitions of the following terms are also incorporated from IFRS 9: derecognition, derivative, fair value, financial guarantee contract. The definition of those terms outlined below (as relevant) are those from IAS 39.

Common examples of financial instruments within the scope of IAS 39

- cash
- demand and time deposits
- commercial paper
- accounts, notes, and loans receivable and payable
- debt and equity securities. These are financial instruments from the perspectives of both the holder and the issuer. This category includes investments in subsidiaries, associates, and joint ventures
- asset backed securities such as collateralised mortgage obligations, repurchase agreements, and securitised packages of receivables
- derivatives, including options, rights, warrants, futures contracts, forward contracts, and swaps.

A **derivative** is a financial instrument:

- Whose value changes in response to the change in an underlying variable such as an interest rate, commodity or security price, or index;
- That requires no initial investment, or one that is smaller than would be required for a contract with similar response to changes in market factors; and
- That is settled at a future date. [IAS 39.9]

Examples of Derivatives:

- Forwards: Contracts to purchase or sell a specific quantity of a financial instrument, a commodity, or a foreign currency at a specified price determined at the outset, with delivery or settlement at a specified future date. Settlement is at maturity by actual delivery of the item specified in the contract, or by a net cash settlement.
- Interest rate swaps and forward rate agreements: Contracts to exchange cash flows as of a specified date or a series of specified dates based on a notional amount and fixed and floating rates.

- Futures: Contracts similar to forwards but with the following differences: futures are generic exchange-traded, whereas forwards are individually tailored. Futures are generally settled through an offsetting (reversing) trade, whereas forwards are generally settled by delivery of the underlying item or cash settlement.
- Options: Contracts that give the purchaser the right, but not the obligation, to buy (call option) or sell (put option) a specified quantity of a particular financial instrument, commodity, or foreign currency, at a specified price (strike price), during or at a specified period of time. These can be individually written or exchange-traded. The purchaser of the option pays the seller (writer) of the option a fee (premium) to compensate the seller for the risk of payments under the option.
- Caps and floors: These are contracts sometimes referred to as interest rate options. An interest rate cap will compensate the purchaser of the cap if interest rates rise above a predetermined rate (strike rate) while an interest rate floor will compensate the purchaser if rates fall below a predetermined rate.

Embedded derivatives

Some contracts that themselves are not financial instruments may nonetheless have financial instruments embedded in them. For example, a contract to purchase a commodity at a fixed price for delivery at a future date has embedded in it a derivative that is indexed to the price of the commodity.

An embedded derivative is a feature within a contract, such that the cash flows associated with that feature behave in a similar fashion to a stand-alone derivative. In the same way that derivatives must be accounted for at fair value on the balance sheet with changes recognised in the income statement, so must some embedded derivatives. IAS 39 requires that an embedded derivative be separated from its host contract and accounted for as a derivative when: [IAS 39.11]

- the economic risks and characteristics of the embedded derivative are not closely related to those of the host contract
- a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative, and
- the entire instrument is not measured at fair value with changes in fair value recognised in the income statement

  If an embedded derivative is separated, the host contract is accounted for under the appropriate standard (for instance, under IAS 39 if the host is a financial instrument).

Appendix A to IAS 39 provides examples of embedded derivatives that are closely related to their hosts, and of those that are not.

Examples of embedded derivatives that are not closely related to their hosts (and therefore must be separately accounted for) include:

- the equity conversion option in debt convertible to ordinary shares (from the perspective of the holder only) [IAS 39.AG30(f)]
- commodity indexed interest or principal payments in host debt contracts[IAS 39.AG30(e)]
- cap and floor options in host debt contracts that are in-the-money when the instrument was issued [IAS 39.AG33(b)]
- leveraged inflation adjustments to lease payments [IAS 39.AG33(f)]
- currency derivatives in purchase or sale contracts for non-financial items where the foreign currency is not that of either counterparty to the contract, is not the currency in which the related good or service is routinely denominated in commercial transactions around the world, and is not the currency that is commonly used in such contracts in the economic environment in which the transaction takes place. [IAS 39.AG33(d)]

If IAS 39 requires that an embedded derivative be separated from its host contract, but the entity is unable to measure the embedded derivative separately, the entire combined contract must be designated as a financial asset as at fair value through profit or loss). [IAS 39.12]

Classification as liability or equity

Since IAS 39 does not address accounting for equity instruments issued by the reporting enterprise but it does deal with accounting for financial liabilities, classification of an instrument as liability or as equity is critical. IAS 32 *Financial Instruments: Presentation* addresses the classification question.

Classification of financial assets

IAS 39 requires financial assets to be classified in one of the following categories: [IAS 39.45]

- Financial assets at fair value through profit or loss
- Available-for-sale financial assets
- Loans and receivables
- Held-to-maturity investments

Those categories are used to determine how a particular financial asset is recognised and measured in the financial statements.

Financial assets at fair value through profit or loss. This category has two subcategories:

- **Designated.** The first includes any financial asset that is designated on initial recognition as one to be measured at fair value with fair value changes in profit or loss.
- **Held for trading.** The second category includes financial assets that are held for trading. All derivatives (except those designated hedging instruments) and financial assets acquired or held for the purpose of selling in the short term or for which there is a recent pattern of short-term profit taking are held for trading. [IAS 39.9]

Available-for-sale financial assets (AFS) are any non-derivative financial assets designated on initial recognition as available for sale or any other instruments that are not classified as as (a) loans and receivables, (b) held-to-maturity investments or (c) financial assets at fair value through profit or loss. [IAS 39.9] AFS assets are measured at fair value in the balance sheet. Fair value changes on AFS assets are recognised directly in equity, through the statement of changes in equity, except for interest on AFS assets (which is recognised in income on an effective yield basis), impairment losses and (for interest-bearing AFS debt instruments) foreign exchange gains or losses. The cumulative gain or loss that was recognised in equity is recognised in profit or loss when an available-for-sale financial asset is derecognised. [IAS 39.55(b)]

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than held for trading or designated on initial recognition as assets at fair value through profit or loss or as available-for-sale. Loans and receivables for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, should be classified as available-for-sale.[IAS 39.9] Loans and receivables are measured at amortised cost. [IAS 39.46(a)]

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments that an entity intends and is able to hold to maturity and that do not meet the definition of loans and receivables and are not designated on initial recognition as assets at fair value through profit or loss or as available for sale. Held-to-maturity investments are measured at amortised cost. If an entity sells a held-to-maturity investment other than in insignificant amounts or as a consequence of a non-recurring, isolated event beyond its control that could not be reasonably anticipated, all of its other held-to-maturity investments must be reclassified as available-for-sale for the current and next two financial reporting years. [IAS 39.9] Held-to-maturity investments are measured at amortised cost. [IAS 39.46(b)]

Classification of financial liabilities

IAS 39 recognises two classes of financial liabilities: [IAS 39.47]

- Financial liabilities at fair value through profit or loss
- Other financial liabilities measured at amortised cost using the effective interest method

The category of financial liability at fair value through profit or loss has two subcategories:

- **Designated.** a financial liability that is designated by the entity as a liability at fair value through profit or loss upon initial recognition
- **Held for trading.** a financial liability classified as held for trading, such as an obligation for securities borrowed in a short sale, which have to be returned in the future

Initial recognition

IAS 39 requires recognition of a financial asset or a financial liability when, and only when, the entity becomes a party to the contractual provisions of the instrument, subject to the following provisions in respect of regular way purchases. [IAS 39.14]

Regular way purchases or sales of a financial asset. A regular way purchase or sale of financial assets is recognised and derecognised using either trade date or settlement date accounting. [IAS 39.38] The method used is to be applied consistently for all purchases and sales of financial assets that belong to the same category of financial asset as defined in IAS 39 (note that for this purpose assets held for trading form a different category from assets designated at fair value through profit or loss). The choice of method is an accounting policy. [IAS 39.38]

IAS 39 requires that all financial assets and all financial liabilities be recognised on the balance sheet. That includes all derivatives. Historically, in many parts of the world, derivatives have not been recognised on company balance sheets. The argument has been that at the time the derivative contract was entered into, there was no amount of cash or other assets paid. Zero cost justified non-recognition, notwithstanding that as time passes and the value of the underlying variable (rate, price, or index) changes, the derivative has a positive (asset) or negative (liability) value.

Initial measurement

Initially, financial assets and liabilities should be measured at fair value (including transaction costs, for assets and liabilities not measured at fair value through profit or loss). [IAS 39.43]

Measurement subsequent to initial recognition

Subsequently, financial assets and liabilities (including derivatives) should be measured at fair value, with the following exceptions: [IAS 39.46-47]

- Loans and receivables, held-to-maturity investments, and non-derivative financial liabilities should be measured at amortised cost using the effective interest method.
- Investments in equity instruments with no reliable fair value measurement (and derivatives indexed to such equity instruments) should be measured at cost.
- Financial assets and liabilities that are designated as a hedged item or hedging instrument are subject to measurement under the hedge accounting requirements of the IAS 39.
- Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition, or that are accounted for using the continuing-involvement method, are subject to particular measurement requirements.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. [IAS 39.9] IAS 39 provides a hierarchy to be used in determining the fair value for a financial instrument: [IAS 39 Appendix A, paragraphs AG69-82]

- Quoted market prices in an active market are the best evidence of fair value and should be used, where they exist, to measure the financial instrument.
- If a market for a financial instrument is not active, an entity establishes fair value by using a valuation technique that makes maximum use of market inputs and includes recent arm's length market transactions, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis, and option pricing models. An acceptable valuation technique incorporates all factors that market participants would consider in setting a price and is consistent with accepted economic methodologies for pricing financial instruments.
- If there is no active market for an equity instrument and the range of reasonable fair values is significant and these estimates cannot be made reliably, then an entity must measure the equity instrument at cost less impairment.

Amortised cost is calculated using the effective interest method. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to the net carrying amount of the financial asset or liability. Financial assets that are not carried at fair value though profit and loss are subject to an impairment test. If expected life cannot be determined reliably, then the contractual life is used.

IAS 39 fair value option

IAS 39 permits entities to designate, at the time of acquisition or issuance, any financial asset or financial liability to be measured at fair value, with value changes recognised in profit or loss. This option is available even if the financial asset or financial liability would ordinarily, by its nature, be measured at amortised cost – but only if fair value can be reliably measured.

In June 2005 the IASB issued its amendment to IAS 39 to restrict the use of the option to designate any financial asset or any financial liability to be measured at fair value through profit and loss (the fair value option). The revisions limit the use of the option to those financial instruments that meet certain conditions: [IAS 39.9]

- the fair value option designation eliminates or significantly reduces an accounting mismatch, or
- a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis by entity's management.

Once an instrument is put in the fair-value-through-profit-and-loss category, it cannot be reclassified out with some exceptions. [IAS 39.50] In October 2008, the IASB issued amendments to IAS 39. The amendments permit reclassification of some financial instruments out of the fair-value-through-profit-or-loss category (FVTPL) and out of the available-for-sale category – for more detail see IAS 39.50(c). In the event of reclassification, additional disclosures are required under IFRS 7*Financial Instruments: Disclosures*. In March 2009 the IASB clarified that reclassifications of financial assets under the October 2008 amendments (see above): on reclassification of a financial asset out of the 'fair value through profit or loss' category, all embedded derivatives have to be (re)assessed and, if necessary, separately accounted for in financial statements.

IAS 39 available for sale option for loans and receivables

IAS 39 permits entities to designate, at the time of acquisition, any loan or receivable as available for sale, in which case it is measured at fair value with changes in fair value recognised in equity.

Impairment

A financial asset or group of assets is impaired, and impairment losses are recognised, only if there is objective evidence as a result of one or more events that occurred after the initial recognition of the asset. An entity is required to assess at each balance sheet date whether there is any objective evidence of impairment. If any such evidence exists, the entity is required to do a detailed impairment calculation to determine whether an impairment loss should be recognised. [IAS 39.58] The amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated cash flows discounted at the financial asset's original effective interest rate. [IAS 39.63]

Assets that are individually assessed and for which no impairment exists are grouped with financial assets with similar credit risk statistics and collectively assessed for impairment. [IAS 39.64]

If, in a subsequent period, the amount of the impairment loss relating to a financial asset carried at amortised cost or a debt instrument carried as available-for-sale decreases due to an event occurring after the impairment was originally recognised, the previously recognised impairment loss is reversed through profit or loss. Impairments relating to investments in available-for-sale equity instruments are not reversed through profit or loss. [IAS 39.65]

Financial guarantees

A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due. [IAS 39.9]

Under IAS 39 as amended, financial guarantee contracts are recognised:

- initially at fair value. If the financial guarantee contract was issued in a stand-alone arm's length transaction to an unrelated party, its fair value at inception is likely to equal the consideration received, unless there is evidence to the contrary.
- subsequently at the higher of (i) the amount determined in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and (ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*. (If specified criteria are met, the issuer may use the fair value

option in IAS 39. Furthermore, different requirements continue to apply in the specialised context of a 'failed' derecognition transaction).

Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is a credit derivative that requires payments in response to changes in a specified credit rating or credit index. These are derivatives and they must be measured at fair value under IAS 39.

Derecognition of a financial asset

The basic premise for the derecognition model in IAS 39 is to determine whether the asset under consideration for derecognition is: [IAS 39.16]

- an asset in its entirety or
- specifically identified cash flows from an asset or
- a fully proportionate share of the cash flows from an asset or
- a fully proportionate share of specifically identified cash flows from a financial asset

Once the asset under consideration for derecognition has been determined, an assessment is made as to whether the asset has been transferred, and if so, whether the transfer of that asset is subsequently eligible for derecognition.

An asset is transferred if either the entity has transferred the contractual rights to receive the cash flows, or the entity has retained the contractual rights to receive the cash flows from the asset, but has assumed a contractual obligation to pass those cash flows on under an arrangement that meets the following three conditions: [IAS 39.17-19]

- the entity has no obligation to pay amounts to the eventual recipient unless it collects equivalent amounts on the original asset
- the entity is prohibited from selling or pledging the original asset (other than as security to the eventual recipient),
- the entity has an obligation to remit those cash flows without material delay

Once an entity has determined that the asset has been transferred, it then determines whether or not it has transferred substantially all of the risks and rewards of ownership of the asset. If substantially all the risks and rewards have been transferred, the asset is derecognised. If substantially all the risks and rewards have been retained, derecognition of the asset is precluded. [IAS 39.20]

If the entity has neither retained nor transferred substantially all of the risks and rewards of the asset, then the entity must assess whether it has relinquished control of the asset or not. If the entity does not control the asset then derecognition is appropriate; however if the entity has retained control of the asset, then the entity continues to recognise the asset to the extent to which it has a continuing involvement in the asset. [IAS 39.30]

These various derecognition steps are summarised in the decision tree in AG36.

Derecognition of a financial liability

A financial liability should be removed from the balance sheet when, and only when, it is extinguished, that is, when the obligation specified in the contract is either discharged or cancelled or expires. [IAS 39.39] Where there has been an exchange between an existing borrower and lender of debt instruments with substantially different terms, or there has been a substantial modification of the terms of an existing financial liability, this transaction is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. A gain or loss from extinguishment of the original financial liability is recognised in profit or loss. [IAS 39.40-41]

Hedge accounting

IAS 39 permits hedge accounting under certain circumstances provided that the hedging relationship is: [IAS 39.88]

- formally designated and documented, including the entity's risk management objective and strategy for undertaking the hedge, identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the entity will assess the hedging instrument's effectiveness and
- expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk as designated and documented, and effectiveness can be reliably measured and
- assessed on an ongoing basis and determined to have been highly effective

Hedging instruments

Hedging instrument is an instrument whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item. [IAS 39.9]

All derivative contracts with an external counterparty may be designated as hedging instruments except for some written options. A non-derivative financial asset or liability may not be designated as a hedging instrument except as a hedge of foreign currency risk. [IAS 39.72]

For hedge accounting purposes, only instruments that involve a party external to the reporting entity can be designated as a hedging instrument. This applies to intragroup transactions as well (with the exception of certain foreign currency hedges of forecast intra group transactions – see below). However, they may qualify for hedge accounting in individual financial statements. [IAS 39.73]

Hedged items

Hedged item is an item that exposes the entity to risk of changes in fair value or future cash flows and is designated as being hedged. [IAS 39.9]

A hedged item can be: [IAS 39.78-82]

- a single recognised asset or liability, firm commitment, highly probable transaction or a net investment in a foreign operation
- a group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations with similar risk characteristics
- a held-to-maturity investment for foreign currency or credit risk (but not for interest risk or prepayment risk)
- a portion of the cash flows or fair value of a financial asset or financial liability or
- a non-financial item for foreign currency risk only for all risks of the entire item
- in a portfolio hedge of interest rate risk (Macro Hedge) only, a portion of the portfolio of financial assets or financial liabilities that share the risk being hedged
- In April 2005, the IASB amended IAS 39 to permit the foreign currency risk of a highly probable intragroup forecast transaction to qualify as the hedged item in a cash flow hedge in consolidated financial statements – provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated financial statements. [IAS 39.80]

In 30 July 2008, the IASB amended IAS 39 to clarify two hedge accounting issues:

- inflation in a financial hedged item
- a one-sided risk in a hedged item.

Effectiveness

IAS 39 requires hedge effectiveness to be assessed both prospectively and retrospectively. To qualify for hedge accounting at the inception of a hedge and, at a minimum, at each reporting date, the changes in the fair value or cash flows of the hedged item attributable to the hedged risk must be expected to be highly effective in offsetting the changes in the fair value or cash flows of the hedging instrument on a prospective basis, and on a retrospective basis where actual results are within a range of 80% to 125%.

All hedge ineffectiveness is recognised immediately in profit or loss (including ineffectiveness within the 80% to 125% window).

Categories of hedges

A **fair value hedge** is a hedge of the exposure to changes in fair value of a recognised asset or liability or a previously unrecognised firm commitment or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss. [IAS 39.86(a)] The gain or loss from the change in fair value of the hedging instrument is recognised immediately in profit or loss. At the same time the carrying amount of the hedged item is adjusted for the corresponding gain or loss with respect to the hedged risk, which is also recognised immediately in net profit or loss. [IAS 39.89]

A **cash flow hedge** is a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss. [IAS 39.86(b)] The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised in other comprehensive income. [IAS 39.95]

If a hedge of a forecast transaction subsequently results in the recognition of a financial asset or a financial liability, any gain or loss on the hedging instrument that was previously recognised directly in equity is 'recycled' into profit or loss in the same period(s) in which the financial asset or liability affects profit or loss. [IAS 39.97]

If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, then the entity has an accounting policy option that must be applied to all such hedges of forecast transactions: [IAS 39.98]

- Same accounting as for recognition of a financial asset or financial liability – any gain or loss on the hedging instrument that was previously recognised in other comprehensive income is 'recycled' into profit or loss in the same period(s) in which the non-financial asset or liability affects profit or loss.

- 'Basis adjustment' of the acquired non-financial asset or liability – the gain or loss on the hedging instrument that was previously recognised in other comprehensive income is removed from equity and is included in the initial cost or other carrying amount of the acquired non-financial asset or liability.

A **hedge of a net investment in a foreign operation** as defined in IAS 21 *The Effects of Changes in Foreign Exchange Rates* is accounted for similarly to a cash flow hedge. [IAS 39.102]

A **hedge of the foreign currency risk of a firm commitment** may be accounted for as a fair value hedge or as a cash flow hedge.

Discontinuation of hedge accounting

Hedge accounting must be discontinued prospectively if: [IAS 39.91 and 39.101]

- the hedging instrument expires or is sold, terminated, or exercised
- the hedge no longer meets the hedge accounting criteria – for example it is no longer effective
- for cash flow hedges the forecast transaction is no longer expected to occur, or
- the entity revokes the hedge designation

In June 2013, the IASB amended IAS 39 to make it clear that there is no need to discontinue hedge accounting if a hedging derivative is novated, provided certain criteria are met. [IAS 39.91 and IAS 39.101]

For the purpose of measuring the carrying amount of the hedged item when fair value hedge accounting ceases, a revised effective interest rate is calculated. [IAS 39.BC35A]

If hedge accounting ceases for a cash flow hedge relationship because the forecast transaction is no longer expected to occur, gains and losses deferred in other comprehensive income must be taken to profit or loss immediately. If the transaction is still expected to occur and the hedge relationship ceases, the amounts accumulated in equity will be retained in equity until the hedged item affects profit or loss. [IAS 39.101(c)]

If a hedged financial instrument that is measured at amortised cost has been adjusted for the gain or loss attributable to the hedged risk in a fair value hedge, this adjustment is amortised to profit or loss based on a recalculated effective interest rate on this date such that the adjustment is fully amortised by the maturity of the instrument. Amortisation may begin as soon as an adjustment exists and must begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risks being hedged.

Disclosure

In 2003 all disclosures about financial instruments were moved to IAS 32, so IAS 32 was renamed *Financial Instruments: Disclosure and Presentation*. In 2005, the IASB issued IFRS 7 *Financial Instruments: Disclosures* to replace the disclosure portions of IAS 32 effective 1 January 2007. IFRS 7 also superseded IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*.

IFRS on Securitisation:

Before we address the IFRS rules, it is important to define the term "securitisation" first. A securitisation transaction is a funding instrument.

In case of a true sale securitisation transaction, designated assets (mainly receivables) are consolidated under a pool (Reference Portfolio) and sold to a Special Purpose Vehicle (SPV) against cash. The SPV is refinancing itself by issuing Notes to Investors. To cover a broader area of Investors the Notes are issued with different risk-return constellations (Senior, Mezzanine and Junior).

In a synthetic securitisation transaction the Originator transfers the risks related to the reference portfolio and to the Originator itself (e.g. late payment of the credit default swap premium) to a Hedge Provider, which passes them to a credit default swap counterparty (Investors) by issuing notes. As in the case of true sale transactions the senior risks are transferred to a senior swap counterparty, the mezzanine risks to a mezzanine swap counterparty and so forth.

If we look more closely to a true sale transaction, we have to identify how the rights and rewards of the cash flows from the assets and the control over the cash flows from the assets in the reference portfolio are addressed. For a financial institution, which is entering a securitisation transaction, it is important to understand if the assets sold can be de-recognized from the balance sheet. The derecognition of assets is regulated under IAS 39 AG 36. According to IAS 39 AG 36 an entity is required to recognise a financial asset or liability on its balance sheet when, and only when, it becomes a party to the contractual provisions of the instrument.

A financial asset (or part of a financial asset) is derecognised when:

(i) the rights to the cash flows from the financial asset are expired;

(ii) the rights to the cash flows from the financial asset and substantially all risks and rewards of ownership of the assets are transferred;

(iii) an obligation to transfer the cash flows from the financial asset is assumed and substantially all risks and rewards of ownership of the assets are transferred;

(iv) all the risks and rewards of the assets are neither transferred nor retained but control of the assets is transferred.

The IFRS stipulates, that these derecognition requirements have to be checked on the consolidated level. It is important to define the consolidation circle. The IFRS defines consolidation under 2 aspects: the legal and the economic aspect.

The legal aspect is described by the control of more than half of the voting rights by the parent company directly or indirectly through subsidiary companies. According to IAS 27, a control exists also, if the parent company holds less than the half of the voting right of a subsidiary, in case the following is fulfilled:

(i) the possibility to dispose over more than half of the voting rights through an agreement with other shareholder;

(ii) the possibility to determine the investment and corporate policy of a company;

(iii) the possibility to elect or to recall the majority of the members of the executive board and/ or supervisory board, whereas the control of the other company rests by these boards;

(iv) the possibility to dispose over the majority of the votes in meetings of the executive board and/ or supervisory board or an equivalent board, whereas the control of the other company rests by these boards.

In SIC 12 the economic aspects which lead to a consolidation of legal independent companies are defined. According to SIC 12 a SPV has to be consolidated if:

(i) the activities are being conducted on behalf of the business needs of the Originator and business needs of investor side, if the SPV is available equally for both sides in a transaction;

(ii) the Originator has the decision-making powers to obtain the majority of the benefits of the activities of the SPV (= rights to dissolve the SPV as well as the effective control over the SPV)

(iii) the Originator has rights to obtain the majority of the benefits of the SPV and therefore may be exposed to risks incident to the activities of the SPV.

After we have determined the consolidation circle it is important to look at the nature of the true sale securitisation transaction. We distinguish between off-balance transactions and on-balance transactions.

The crucial criterion whether a transaction is accounted for on- or off-balance is the transfer of risks and rewards arising from the reference portfolio. If there has been no transfer of the risks and rewards the only way of derecognising the assets is through a valid pass-through-arrangement. According to IAS 39.19 a pass-through-arrangement is valid, if the Originator fulfils all three of the following requirements:

(i) the entity has no obligation to pay amounts to eventual recipients unless it collects equivalent amounts from the original asset;

(ii) the entity is prohibited from selling or pledging the original asset, other than as security to the eventual recipients for the obligation to pay them cash flows;

(iii) the entity is obliged to remit any cash flows it collects without material delay.

If the above listed criteria for derecognition of the assets is not fulfilled the assets have to be fully recognised in accordance with the IAS. These transactions are called on-balance transactions.

A central role in the accounting of securitisation transactions is the Excess Spread. To understand the term, we have to look at the financial flow between the Originator and the SPV. All the payments of the reference portfolio are transferred to the SPV on a regular basis. The SPV uses these amounts to make payments to the investors according to the priority of payments. From the initial payment of the Originator the SPV subtracts all the current losses, the external costs and the interests paid to the investors. The residual amount is called Excess Spread.

The Excess Spread can be transferred back to the Originator in two ways:

(i) as a deferred purchase price;

(ii) as a dividend under a preference share that the Originator holds of the SPV.

Another aspect to be addressed is provisioning. Because of an economical exposure to possible reference portfolio losses, portfolio-based provisions have to be made, up to the limit outstanding under the reference portfolio.

First we will cover the on-balance sheet true sale transactions.

If losses occur in the reference portfolio these losses are deducted from the Excess Spread.

i. The Originator has to calculate individual and portfolio based loan loss provisions.

ii. For the SPV and the Junior Piece Holder (JPH) no additional bookings needed.

If the losses exceed the Excess Spread, the exceeding part directly hits the investors starting with the holder of the Junior Piece.

If the losses are up to the Junior Note the Originator hat to calculate for the increased loan losses additional individual loan loss provisions. The amount of losses above the Excess Spread creates receivable against the JPH.

For the SPV no additional bookings are needed. The JPH will create liability against the Originator covering the losses above the Excess Spread.

In case the Excess Spread exceeds the actual reference portfolio losses, the investors will be paid back until their "loss ledger" equals zero.

In on-balance transactions the Originator bears the losses up to the Excess Spread. Losses exceeding the Excess Spread are borne by the investors.

For the off-balance sheet true sale transactions the accounting of the losses is similar to the on-balance transactions just that the securitised assets are shown on the balance sheet of the SPV. There will be only a conversion between the Originator and the SPV. (The SPV has to calculate and to book individual and portfolio-based loan loss provisions)

Another important component of a securitisation transaction is the liquidity facility. This is a credit line of usually 364 days that a bank provides to the SPV to buffer short-term cash fluctuations. The rating will be in most cases equal to the rating of the senior notes.

The liquidity facility will be booked by the bank as a loan (drawn or undrawn) to the SPV with subparticipation by 3rd party. The 3rd party is a company that secures the reimbursement obligation to the bank through a deposit made by the bank. This company books a liquidity facility to the SPV for a securitisation with a rating equal to the rating of the senior notes.

Another aspect which has to be taken into account is the commingling and set-off risk. This can appear in case of insolvency of the Originator. To cover these risks a loan will be granted by the bank (Originator) to the SPV. If all the loan payments are properly transferred the loan will be repaid to the Originator.

These reserves have to be booked according to IFRS as follows:

(i) by the bank as a loan with sub-participation by 3rd party;

(ii) by the 3rd party as a loan to the SPV and as a liability with the Originator;

(iii) by the SPV as a cash deposit.

If it is probable that the deposit will be used the 3rd party has to allocate a provision for the estimated losses.

One more element can be part of the securitisation transaction. The bank can provide a subordinated loan to the SPV to cover the SPVs' upfront cost of the transaction. This additional loan will be addressed in the same manner as the liquidity facility or the commingling and set-off reserves.

The upfront costs include:

(i) structuring and placement fee;

(ii) fees for legal and tax advice and for the pool audit;

(iii) fees to the rating agencies;

(iv) fees to the trustees;

(v) fees for establishing the SPV and

(vi) fees for the marketing of the transaction.

In case of (i), (ii) and (iii) the costs can be amortized over the expected average lifetime of the transaction.

In case of (iv), (v) and (vi) the costs are shown as expenses immediately.

IAS 39 on Financial Instruments: Recognition and Measurement, are considered by many to be overly complex and difficult to apply. The IASB's project seeks to rectify these difficulties in a "fast-tracked" project. In addition to IFRS 9, the IASB has also recently released an exposure draft out of the second phase of the project covering amortised cost and impairment (refer below), and an exposure draft from the third phase of the project, hedge accounting, is expected by the end of the year.

IFRS 9 Financial Instruments introduces a new classification and measurement regime for financial assets within its scope. As a result of ongoing discussions about measurement of own credit risk when fair valuing financial liabilities, accounting for financial liabilities will continue to be performed under IAS 39 until further amendments are made by the IASB to IFRS 9.

In summary, IFRS 9 proposes that:

debt instruments meeting both a 'business model' test and a 'cash flow characteristics' test are measured at amortised cost (the use of fair value is optional in some limited circumstances)

investments in equity instruments can be designated as 'fair value through other comprehensive income' with only dividends being recognised in profit or loss all other instruments (including all derivatives) are measured at fair value with changes recognised in the profit or loss the concept of 'embedded derivatives' does not apply to financial assets within the scope of the Standard and the entire instrument must be classified and measured in accordance with the above guidelines unquoted equity instruments can no longer be measured at cost less impairment (must be at fair value).

What are the 'business model' and 'cash flow characteristics' tests for amortised cost classification?

IFRS 9 states that in determining the measurement attribute for a financial asset (i.e., amortised cost or fair value), an entity must use two classification criteria – a business model test and a cash flow characteristics test. If the financial asset satisfies the two classification criteria, the financial asset typically must be measured at amortised cost. An entity may irrevocably elect on initial recognition to designate a financial asset as fair value through profit or loss (FVTPL) if that designation eliminates or significantly reduces an accounting mismatch had the financial asset been measured at amortised cost. This is the so-called "fair value option."

Business Model Test

The business model test requires an entity to assess whether its business objective for financial assets is to collect the contractual cash flows of the assets rather than realise their fair value change from sale before their contractual maturity. This determination is made at a business unit level and not an individual financial instrument level and therefore is not based on management's intent for individual instruments.

IFRS 9 acknowledges that an entity may have different business units that are managed differently. For example, an entity may have a retail banking business whose objective is to collect contractual cash flows of loan assets and an investment banking business whose objective is to realise fair value changes through the sale of loan assets before their maturity. Therefore, financial instruments held in the retail banking business that give rise to cash flows that are payments of principal and interest (see Cash Flow Characteristics Test below) may qualify for amortised cost measurement even if similar financial instruments in the investment banking business do not. Note that all instruments that meet the existing held-for-trading definition in IAS 39 will continue to be classified as FVTPL because they are not held to collect the contractual cash flows of the instrument.

Because the assessment under the business model test is performed at the portfolio level and not the financial instrument level, an entity's business model can be to hold financial assets to collect contractual cash flows even when there are some sales of financial assets. For example, an entity's conclusion that it holds investments to collect their contractual cash flows is still valid even if the entity sells some of the investments to fund capital expenditures.

Cash Flow Characteristics Test

IFRS 9 requires an entity to assess the contractual cash flow characteristics of a financial asset. The concept is that only instruments with contractual cash flows of principal and interest on principal could qualify for amortised cost measurement. IFRS 9 describes interest as consideration for the time value of money and credit risk associated with the principal outstanding during a specific period. Therefore, an investment in a convertible debt instrument would not qualify because of the inclusion of the conversion option, which is not deemed to represent payments of principal and interest.

The cash flow characteristics criterion is met when the cash flows on a loan are entirely fixed (e.g., a fixed interest rate loan or zero coupon bond), when interest is floating (e.g., when interest is contractually linked to BKBM), or when interest is a combination of fixed and floating (e.g., BKBM plus a fixed spread).

Financial assets that do not meet the above criteria are required to be measured at fair value, including all equity investments, all derivative assets, all trading assets, and those loans, receivables, and debt securities that do not meet the two criteria described above.

Applicable date and transition

IFRS 9 is applicable to annual reporting periods beginning on or after 1 January 2013, but can be early adopted from December 2009 year ends. IFRS 9 is applied on a modified retrospective basis, including permitting certain instruments to be reclassified based on conditions at the date of application. Exemptions from the requirement to restate comparative information are also available for early adopters.

THE STANDING INTERPRETATIONS COMMITTEE - BACKGROUND

The board of the International Accounting Standards Committee (IASC) formed the Standing Interpretations Committee (SIC) in 1997. It was founded with the objective of developing interpretations of International Accounting Standards (IASs) to be applied where the standards are silent or unclear.

More specifically the operating procedures of the SIC state their objective is to:

- review accounting issues that are likely to receive divergent or unacceptable treatment in the absence of authoritative guidance, with a view to reaching a consensus as to the appropriate accounting treatment;
- carry out the review on a timely basis and within the context of the existing IASs and the IASC's Framework for the Preparation and Presentation of Financial Statements.

The interpretations of potentially contentious accounting issues should enhance the rigorous application and worldwide comparability of financial statements that are prepared using IAS.

Approach

The SIC uses the approach described in IAS 1 (revised) *Presentation of Financial Statements* for dealing with transactions for which there is no IAS i.e.,

- making analogies with the requirements and guidance in IASs dealing with similar and related issues;
- applying the definitions, recognition and measurement criteria for assets, liabilities, income and expenses set out in the IASC Framework; and
- taking into consideration the pronouncements of other standard setting bodies and accepted industry practices to the extent, but only to the extent, that these are consistent with IASs and the framework.

SICS

The interpretations are described as SIC–1, SIC–2, etc., and they share certain characteristics:

- they follow a consistent format;

- each relates to a point of interpretation (or points of interpretation) of a single standard. As a result they tend to be quite short documents;
- the accounting issues reviewed are those which are judged to be of reasonably widespread importance and not issues of concern to one or only a small number of companies.

After approval by the board the interpretations become part of the IASC's authoritative literature. Financial statements should not be described as complying with IASs unless they comply with all the requirements of each applicable Standard and each applicable Interpretation issued by the SIC. Interpretations are not intended to apply to immaterial items.

SIC-12 — Consolidation – Special Purpose Entities

History

o Issued November 1998.

o Effective date: Annual financial periods beginning on or after 1 July 1999.

o Amended by IFRIC: November 2004 to remove the exclusion of equity compensation plans from the scope of SIC-12

o Superseded by IFRS 10 Consolidated Financial Statements and IFRS 12 Disclosure of Interests in Other Entities, effective for annual periods beginning on or after 1 January 2013

Summary of SIC-12

SIC-12 addresses when a special purpose entity should be consolidated by a reporting enterprise under the consolidation principles in IAS 27. Under SIC-12, an entity must consolidate a special purpose entity ("SPE") when, in substance, the entity controls the SPE. The control of an SPE by an entity may be indicated if:

o The SPE conducts its activities to meet the entity's specific needs

o The entity has decision-making powers to obtain the majority of the benefits of the SPE's activities o The entity is able to obtain the majority of the benefits of the SPE's activities through an 'auto-pilot' mechanism

o By having a right to the majority of the SPE's benefits, the entity is exposed to the SPE's business risks

o The entity has the majority of residual interest in the SPE

Examples of SPEs include entities set up to effect a lease, a securitisation of financial assets, or R&D activities. The concept of control used in IAS 27 requires having the ability to direct or dominate decision making accompanied by the objective of obtaining benefits from the SPE's activities.

Some enterprises may also need to separately evaluate the topic of derecognition of assets, for example, related to assets transferred to an SPE. In some circumstances, such a transfer of assets may result in those assets being derecognised and accounted for as a sale. Even if the transfer qualifies as a sale, the provisions of IAS 27 and SIC-12 may mean that the enterprise should consolidate the SPE. SIC-12 does not address the circumstances in which sale treatment should apply for the reporting enterprise or the elimination of the consequences of such a sale upon consolidation.

IFRS 7 — Financial Instruments: Disclosures

Overview

IFRS 7 Financial Instruments: Disclosures requires disclosure of information about the significance of financial instruments to an entity, and the nature and extent of risks arising from those financial instruments, both in qualitative and quantitative terms. Specific disclosures are required in relation to transferred financial assets and a number of other matters.

IFRS 7 was originally issued in August 2005 and applies to annual periods beginning on or after 1 January 2007.

19 November 2013	*IFRS 9 Financial Instruments (Hedge Accounting and amendments to IFRS 9, IFRS 7 and IAS 39)* issued,	Applies when IFRS 9 is

	implementing additional disclosures (and consequential amendments) resulting from the introduction of the hedge accounting chapter in IFRS 9	applied*

* The release of IFRS 9 *Financial Instruments* (2013) on 19 November 2013 contained no stated effective date and contained consequential amendments which removed the mandatory effective date of IFRS 9 (2010) and IFRS 9 (2009), leaving the effective date open but leaving each standard available for application. Accordingly, these amendments apply when IFRS 9 is applied.

Overview of IFRS 7

- adds certain new disclosures about financial instruments to those currently required by IAS 32;
- replaces the disclosures previously required by IAS 30; and
- puts all of those financial instruments disclosures together in a new standard on *Financial Instruments: Disclosures*. The remaining parts of IAS 32 deal only with financial instruments presentation matters.

Disclosure requirements of IFRS 7

IFRS requires certain disclosures to be presented by category of instrument based on the IAS 39 measurement categories. Certain other disclosures are required by class of financial instrument. For those disclosures an entity must group its financial instruments into classes of similar instruments as appropriate to the nature of the information presented. [IFRS 7.6]

The two main categories of disclosures required by IFRS 7 are:

1. information about the significance of financial instruments.
2. information about the nature and extent of risks arising from financial instruments

Information about the significance of financial instruments

Statement of financial position

- Disclose the significance of financial instruments for an entity's financial position and performance. [IFRS 7.7] This includes disclosures for each of the following categories: [IFRS 7.8]

- financial assets measured at fair value through profit and loss, showing separately those held for trading and those designated at initial recognition
- held-to-maturity investments
- loans and receivables
- available-for-sale assets
- financial liabilities at fair value through profit and loss, showing separately those held for trading and those designated at initial recognition
- financial liabilities measured at amortised cost
- Other balance sheet-related disclosures:
- special disclosures about financial assets and financial liabilities designated to be measured at fair value through profit and loss, including disclosures about credit risk and market risk, changes in fair values attributable to these risks and the methods of measurement.[IFRS 7.9-11]
- reclassifications of financial instruments from one category to another (e.g. from fair value to amortised cost or vice versa) [IFRS 7.12-12A]
- information about financial assets pledged as collateral and about financial or non-financial assets held as collateral [IFRS 7.14-15]
- reconciliation of the allowance account for credit losses (bad debts) by class of financial assets[IFRS 7.16]
- information about compound financial instruments with multiple embedded derivatives [IFRS 7.17]
- breaches of terms of loan agreements [IFRS 7.18-19]

Statement of comprehensive income

- Items of income, expense, gains, and losses, with separate disclosure of gains and losses from: [IFRS 7.20(a)]
    - financial assets measured at fair value through profit and loss, showing separately those held for trading and those designated at initial recognition.
    - held-to-maturity investments.
    - loans and receivables.
    - available-for-sale assets.

- financial liabilities measured at fair value through profit and loss, showing separately those held for trading and those designated at initial recognition.
- financial liabilities measured at amortised cost.

- Other income statement-related disclosures:
  - total interest income and total interest expense for those financial instruments that are not measured at fair value through profit and loss [IFRS 7.20(b)]
  - fee income and expense [IFRS 7.20(c)]
  - amount of impairment losses by class of financial assets [IFRS 7.20(e)]
  - interest income on impaired financial assets [IFRS 7.20(d)]

Other disclosures

- Accounting policies for financial instruments [IFRS 7.21]
- Information about hedge accounting, including: [IFRS 7.22]
- description of each hedge, hedging instrument, and fair values of those instruments, and nature of risks being hedged
- for cash flow hedges, the periods in which the cash flows are expected to occur, when they are expected to enter into the determination of profit or loss, and a description of any forecast transaction for which hedge accounting had previously been used but which is no longer expected to occur
- if a gain or loss on a hedging instrument in a cash flow hedge has been recognised in other comprehensive income, an entity should disclose the following: [IAS 7.23]
- the amount that was so recognised in other comprehensive income during the period
- the amount that was removed from equity and included in profit or loss for the period
- the amount that was removed from equity during the period and included in the initial measurement of the acquisition cost or other carrying amount of a non-financial asset or non- financial liability in a hedged highly probable forecast transaction

  Note: Where IFRS 9 *Financial Instruments* (2013) is applied, revised disclosure requirements apply. The required hedge accounting disclosures apply where the entity elects to adopt hedge accounting and require information to be provided in three broad categories: (1) the entity's risk management strategy and how it is applied to manage risk (2) how the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows, and (3) the effect that hedge accounting has had on the entity's statement of financial position, statement of comprehensive income and statement of changes in equity. The disclosures are required to be presented in a single note or separate section in its financial statements, although some information can be incorporated by reference.

- For fair value hedges, information about the fair value changes of the hedging instrument and the hedged item [IFRS 7.24(a)]
- Hedge ineffectiveness recognised in profit and loss (separately for cash flow hedges and hedges of a net investment in a foreign operation) [IFRS 7.24(b-c)]
- Information about the fair values of each class of financial asset and financial liability, along with: [IFRS 7.25-30]
- comparable carrying amounts
- description of how fair value was determined
- the level of inputs used in determining fair value
- reconciliations of movements between levels of fair value measurement hierarchy additional disclosures for financial instruments whose fair value is determined using level 3 inputs including impacts on profit and loss, other comprehensive income and sensitivity analysis
- information if fair value cannot be reliably measured

The fair value hierarchy introduces 3 levels of inputs based on the lowest level of input significant to the overall fair value (IFRS 7.27A-27B):

- Level 1 – quoted prices for similar instruments
- Level 2 – directly observable market inputs other than Level 1 inputs
- Level 3 – inputs not based on observable market data

Note that disclosure of fair values is not required when the carrying amount is a reasonable approximation of fair value, such as short-term trade receivables and payables, or for instruments whose fair value cannot be measured reliably. [IFRS 7.29(a)]

Nature and extent of exposure to risks arising from financial instruments

Qualitative disclosures [IFRS 7.33]

The qualitative disclosures describe:

- risk exposures for each type of financial instrument
- management's objectives, policies, and processes for managing those risks

- changes from the prior period

Quantitative disclosures

- The quantitative disclosures provide information about the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel. These disclosures include: [IFRS 7.34]
- summary quantitative data about exposure to each risk at the reporting date
- disclosures about credit risk, liquidity risk, and market risk and how these risks are managed as further described below
- concentrations of risk

Credit risk

- Credit risk is the risk that one party to a financial instrument will cause a loss for the other party by failing to pay for its obligation. [IFRS 7. Appendix A]
- Disclosures about credit risk include: [IFRS 7.36-38]
- maximum amount of exposure (before deducting the value of collateral), description of collateral, information about credit quality of financial assets that are neither past due nor impaired, and information about credit quality of financial assets whose terms have been renegotiated [IFRS 7.36]
- for financial assets that are past due or impaired, analytical disclosures are required [IFRS 7.37]
- information about collateral or other credit enhancements obtained or called [IFRS 7.38]

Liquidity risk

- Liquidity risk is the risk that an entity will have difficulties in paying its financial liabilities. [IFRS 7. Appendix A]
- Disclosures about liquidity risk include: [IFRS 7.39]
- a maturity analysis of financial liabilities
- description of approach to risk management

Market risk [IFRS 7.40-42]

- Market risk is the risk that the fair value or cash flows of a financial instrument will fluctuate due to changes in market prices. Market risk reflects interest rate risk, currency risk and other price risks. [IFRS 7. Appendix A]
- Disclosures about market risk include:

- a sensitivity analysis of each type of market risk to which the entity is exposed
- additional information if the sensitivity analysis is not representative of the entity's risk exposure (for example because exposures during the year were different to exposures at year-end).
- IFRS 7 provides that if an entity prepares a sensitivity analysis such as value-at-risk for management purposes that reflects interdependencies of more than one component of market risk (for instance, interest risk and foreign currency risk combined), it may disclose that analysis instead of a separate sensitivity analysis for each type of market risk

Transfers of financial assets [IFRS 7.42A-H]

An entity shall disclose information that enables users of its financial statements:

a) to understand the relationship between transferred financial assets that are not derecognised in their entirety and the associated liabilities; and
b) to evaluate the nature of, and risks associated with, the entity's continuing involvement in derecognised financial assets. [IFRS 7 42B]

Transferred financial assets that are not derecognised in their entirety

- Required disclosures include description of the nature of the transferred assets, nature of risk and rewards as well as description of the nature and quantitative disclosure depicting relationship between transferred financial assets and the associated liabilities. [IFRS 7.42D]

Transferred financial assets that are derecognised in their entirety

- Required disclosures include the carrying amount of the assets and liabilities recognised, fair value of the assets and liabilities that represent continuing involvement, maximum exposure to loss from the continuing involvement as well as maturity analysis of the undiscounted cash flows to repurchase the derecognised financial assets. [IFRS 7.42E]
- Additional disclosures are required for any gain or loss recognised at the date of transfer of the assets, income or expenses recognise from the entity's continuing involvement in the derecognised financial assets as well as details of uneven distribution of proceed from transfer activity throughout the reporting period. [IFRS 7.42G]

RBI Guidelines on Accounting Treatment of Securitisation Transaction:

Moving assets off the Originator's balance sheet

Securitisation necessarily involves assignment of assets by the Originator to an SPV. This has implications for Originators in the areas of capital adequacy (for financial intermediaries), accounting treatment and taxation. The regulator's role in each of these is discussed below:

a. **Capital Relief**

   Financial intermediaries can use securitisation to free a portion of their regulatory capital. RBI, which prescribes capital adequacy requirements for these entities, would hence be required to lay down norms for "true sale" and the capital relief. The norms would aim at preventing Originators from getting the benefit of capital relief in events where they either retain asset risk or provide recourse to the investors. These norms would be purely from the point of view of capital adequacy and independent of what "true sale" may mean in the legal, accounting or taxation context.

b. **Post-securitisation financial health of Originators**

The pool assets that are securitised are picked and chosen out of an Originator's total portfolio. In securitisation parlance, good assets are "cherry-picked" to make the securities issued attractive to investors. This exercise carries with it the risk that (post-securitisation) the Originator's balance sheet would be left with assets of poorer quality, except in the cases where it can generate fresh assets of the quality of the securitised assets. The RBI would hence be concerned that the financial health of Originators could be in jeopardy, if securitisation is resorted to in too large a scale.

IOSCO Regulations and Recommendations on Securitisation:

The International Organization of Securities Commissions (IOSCO), established in 1983, is the acknowledged international body that brings together the world's securities regulators and is recognized as the global standard setter for the securities sector. IOSCO develops, implements, and promotes adherence to internationally recognized standards for securities regulation, and is working intensively with the G20 and the Financial Stability Board (FSB) on the global regulatory reform agenda.

IOSCO's membership regulates more than 95% of the world's securities markets. Its members include over 120 securities regulators and 80 other securities markets participants (i.e. stock exchanges, financial regional and international organizations etc.). IOSCO is the only international financial regulatory organization which includes all the major emerging markets jurisdictions within its membership.

IOSCO Objectives

The member agencies currently assembled together in the International Organization of Securities Commissions have resolved, through its permanent structures:

- to cooperate in developing, implementing and promoting adherence to internationally recognised and consistent standards of regulation, oversight and enforcement in order to protect investors, maintain fair, efficient and transparent markets, and seek to address systemic risks;
- to enhance investor protection and promote investor confidence in the integrity of securities markets, through strengthened information exchange and cooperation in enforcement against misconduct and in supervision of markets and market intermediaries; and
- to exchange information at both global and regional levels on their respective experiences in order to assist the development of markets, strengthen market infrastructure and implement appropriate regulation.

The International Organisation of Securities Commissions has set out 10 recommendations on securitisation, to restore confidence in the practice as a useful alternative source of funding for the banking sector.

The IOSCO recommendations include aligning incentives of investors and securitisers, including mandating retention of risk in securitisation products where appropriate; clarity over the party on which obligations are imposed and risk retention; greater transparency and standardisation; standardised asset level templates and more disclosure to assist investors in making decisions.

Investors should receive information such as average expected loss coverage and average expected life of the asset pool at all times. Key indicators including risk/reward profile, fees and scenario analysis should also be provided free of charge.

IOSCO also sets out five areas where further work is needed, including on prudential treatment of securitisation products, account issues, guidance on cross-border regulation, standardisation and secondary markets, and sound mortgage underwriting practices.

Lack of transparency over securitised instruments was a key element in the financial crisis. Securitised products were often based on of high-risk, poor-quality mortgages that were issued to consumers who lacked the means to pay back their debts. The securitised products were passed around between market participants and investors, who were often unaware of the high risk due to the complicated and non-transparent nature of the products.

FASB Statements on Securitisation:

The Financial Accounting Standards Board (FASB) is a private, not-for-profit organization whose primary purpose is to develop generally accepted accounting principles (GAAP) within the United States in the public's interest. The Securities and Exchange Commission (SEC) designated the FASB as the organization responsible for setting accounting standards for public companies in the U.S. It was created in 1973, replacing the Committee on Accounting Procedure (CAP) and the Accounting Principles Board (APB) of the American Institute of Certified Public Accountants (AICPA).

The FASB's mission is "to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information." To achieve this, FASB has five goals:

- Improve the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability, and on the qualities of comparability and consistency.

- Keep standards current to reflect changes in methods of doing business and in the economy.

- Consider promptly any significant areas of deficiency in financial reporting that might be improved through standard setting.

- Promote international convergence of accounting standards concurrent with improving the quality of financial reporting.

- Improve common understanding of the nature and purposes of information in financial reports.

FASB STATEMENT NO. 65
ITEMS PREVIOUSLY REPORTED AS ASSETS AND LIABILITIES
(ISSUED 03/12)

This Statement establishes accounting and financial reporting standards that reclassify, as deferred outflows of resources or deferred inflows of resources, certain items that were previously reported as assets and liabilities and recognizes, as outflows of resources or inflows of resources, certain items that were previously reported as assets and liabilities.

Concepts Statement No. 4, *Elements of Financial Statements,* introduced and defined the elements included in financial statements, including deferred outflows of resources and deferred inflows of resources. In addition, Concepts Statement 4 provides that reporting a deferred outflow of resources or a deferred inflow of resources should be limited to those instances identified by the Board in authoritative pronouncements that are established after applicable due process. Prior to the issuance of this Statement, only two such pronouncements have been issued. Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments,* requires the reporting of a deferred outflow of resources or a deferred inflow of resources for the changes in fair value of hedging derivative instruments, and Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, requires a deferred inflow of resources to be reported by a transferor government in a qualifying service concession arrangement. This Statement amends the financial statement element classification of certain items previously reported as assets and liabilities to be consistent with the definitions in Concepts Statement 4.

This Statement also provides other financial reporting guidance related to the impact of the financial statement elements deferred outflows of resources and deferred inflows of resources, such as changes in the determination of the major fund calculations and limiting the use of the term *deferred* in financial statement presentations.

The provisions of this Statement are effective for financial statements for periods beginning after December 15, 2012. Earlier application is encouraged.

How the Changes in This Statement Will Improve Financial Reporting

The requirements of this Statement will improve financial reporting by clarifying the appropriate use of the financial statement elements deferred outflows of resources and deferred inflows of resources to ensure consistency in financial reporting.

FASB Statement No. 115

ACCOUNTING FOR CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES (ISSUED 5/93)

Summary

This Statement addresses the accounting and reporting for investments in equity securities that have readily determinable fair values and for all investments in debt securities. Those investments are to be classified in three categories and accounted for as follows:

Debt securities that the enterprise has the positive intent and ability to hold to maturity are classified as *held-to-maturity securities* and reported at amortized cost.

Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as *trading securities* and reported at fair value, with unrealized gains and losses included in earnings.

Debt and equity securities not classified as either held-to-maturity securities or trading securities are classified as *available-for-sale securities* and reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of shareholders' equity.

This Statement does not apply to unsecuritized loans. However, after mortgage loans are converted to mortgage-backed securities, they are subject to its provisions. This Statement supersedes FASB Statement No. 12, *Accounting for Certain Marketable Securities,* and related

Interpretations and amends FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities,* to eliminate mortgage-backed securities from its scope.

This Statement is effective for fiscal years beginning after December 15, 1993. It is to be initially applied as of the beginning of an enterprise's fiscal year and cannot be applied retroactively to prior years' financial statements. However, an enterprise may elect to initially apply this Statement as of the end of an earlier fiscal year for which annual financial statements have not previously been issued.

FASB STATEMENT NO. 125

ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES (ISSUED 6/96)

Summary

This Statement provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. Those standards are based on consistent application of a *financial-components approach* that focuses on control. Under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. This Statement provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

A transfer of financial assets in which the transferor surrenders control over those assets is accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right—to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity and the holders of beneficial interests in

that entity have the right—free of conditions that constrain them from taking advantage of that right—to pledge or exchange those interests.

c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable.

This Statement requires that liabilities and derivatives incurred or obtained by transferors as part of a transfer of financial assets be initially measured at fair value, if practicable. It also requires that servicing assets and other retained interests in the transferred assets be measured by allocating the previous carrying amount between the assets sold, if any, and retained interests, if any, based on their relative fair values at the date of the transfer.

This Statement requires that servicing assets and liabilities be subsequently measured by (a) amortization in proportion to and over the period of estimated net servicing income or loss and (b) assessment for asset impairment or increased obligation based on their fair values.

This Statement requires that debtors reclassify financial assets pledged as collateral and that secured parties recognize those assets and their obligation to return them in certain circumstances in which the secured party has taken control of those assets.

This Statement requires that a liability be derecognized if and only if either (a) the debtor pays the creditor and is relieved of its obligation for the liability or (b) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. Therefore, a liability is not considered extinguished by an in-substance defeasance.

This Statement provides implementation guidance for assessing isolation of transferred assets and for accounting for transfers of partial interests, servicing of financial assets, securitizations, transfers of sales-type and direct financing lease receivables, securities lending transactions, repurchase agreements including "dollar rolls," "wash sales," loan syndications and participations, risk participations in banker's acceptances, factoring arrangements, transfers of receivables with recourse, and extinguishments of liabilities.

This Statement supersedes FASB Statements No. 76, *Extinguishment of Debt,* and No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*. This Statement amends FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* to clarify that a debt security may not be classified as held-to-maturity if it can be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. This Statement amends and extends to all servicing assets and liabilities the accounting standards for mortgage servicing rights now in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities,*and supersedes FASB Statement No. 122, *Accounting for Mortgage Servicing Rights*. This Statement also supersedes Technical Bulletins No. 84-4, *In-Substance Defeasance of Debt,* No. 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs),* and No. 87-3, *Accounting for Mortgage Servicing Fees and Rights*.

This Statement is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996, and is to be applied prospectively. Earlier or retroactive application is not permitted.

FASB Statement No. 134

Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise

INTRODUCTION

1. FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities, establishes accounting and reporting standards for certain activities of mortgage banking enterprises and other enterprises that conduct operations that are substantially similar to the primary operations of a mortgage banking enterprise.

2. Statement 65, as amended by FASB Statements No. 115, Accounting for Certain Investments in Debt and Equity Securities, and No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, requires that after the securitization of a mortgage loan held for sale, an entity engaged in mortgage banking activities classify the resulting mortgage-backed security as a trading security. This Statement further amends Statement 65 to require that after the securitization of mortgage loans held for sale, an entity engaged in mortgage banking activities classify the resulting mortgage-backed securities or other retained

interests based on its ability and intent to sell or hold those investments. This Statement conforms the subsequent accounting for securities retained after the securitization of mortgage loans by a mortgage banking enterprise with the subsequent accounting for securities retained after the securitization of other types of assets by a nonmortgage banking enterprise.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendment to Statement 65

3. The second sentence of paragraph 6 of Statement 65, which was added by Statement 115 and amended by Statement 125, is deleted. The following is added to the end of paragraph 6:

   After the securitization of a mortgage loan held for sale, any retained mortgage-backed securities shall be classified in accordance with the provisions of Statement 115. However, a mortgage banking enterprise must classify as trading any retained mortgage-backed securities that it commits to sell before or during the securitization process.

4. The fifth sentence of paragraph 4 of Statement 65, as amended by Statement 115, FASB Statement No. 124, Accounting for Certain Investments Held by Not-for-Profit Organizations, and FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, is deleted.

Amendment to Statement 115

5. The third and fourth sentences of paragraph 12(a) of Statement 115 are deleted.

Effective Date and Transition

6. This Statement shall be effective for the first fiscal quarter beginning after December 15, 1998. Early application is encouraged and is permitted as of the issuance of this Statement. On the date this Statement is initially applied, an enterprise may reclassify mortgage-backed securities and other beneficial interests retained after the securitization of mortgage loans held for sale from the trading category, except for those with sales commitments in place. 1 Those securities and other interests shall be classified based on

the entity's ability and intent, on the date this Statement is initially applied, to hold those investments. Transfers from the trading
category that result from implementing this Statement shall be accounted for in accordance with paragraph 15(a) of Statement 115.

The provisions of this Statement need not be applied to immaterial items.

Background Information

7. Prior to its amendment by Statements 115 and 125, Statement 65 required that mortgage loans and mortgage-backed securities be classified as either held for sale or long-term investments. Mortgage loans and mortgage-backed securities held for sale were reported at the lower of cost or market value. Statement 65 permitted an enterprise to transfer loans or mortgage-backed securities from a held-for-sale to a long-term investment category if the enterprise had both the ability and the intent to hold those loans or securities for the foreseeable future or until maturity.

8. Statement 115 did not allow for debt or marketable equity securities to be measured at the lower of cost or market and amended Statement 65 to require that "the securitization of a mortgage loan held for sale shall be accounted for as the sale of the mortgage loan and the purchase of a mortgage-backed security classified as a trading security at fair value" (paragraph 128(c)). Statement 125 amended Statement 115 and required that "after the securitization of a mortgage loan held for sale, the mortgage-backed security shall be classified as a trading security" (paragraph 237(a)). As a result, Statement 65, as amended, required that an enterprise engaged in mortgage banking activities classify all mortgage-backed securities retained after the securitization of mortgage loans held for sale as trading under Statement 115, regardless of whether the enterprise intended to sell those securities or hold them as long-term investments. Therefore, all unrealized gains or losses on those securities were recognized currently in earnings.

Decision to Amend Statement 65

9. In March 1997, the Mortgage Bankers Association of America (MBAA) asked the Board to reconsider the accounting for securities retained after the securitization of mortgage loans held for sale. The MBAA explained that an enterprise engaged in mortgage banking activities was required to classify those securities exclusively as trading. The MBAA

observed that a nonmortgage banking enterprise engaged in the securitization of other types of assets was able to classify the retained securities as trading, available-for-sale, or held-to-maturity under Statement 115.

10. The Board believes that the fair value of financial assets and liabilities provides more relevant and understandable information than cost or cost-based measures and has a project on its agenda to consider measuring all financial instruments at fair value. The Board, therefore, considered rejecting the MBAA's request to amend Statement 65 and, instead, addressing the issues as part of its fair value project. However, because the requirements for entities engaged in mortgage banking activities were more stringent than for other entities and it is expected to be several years before a standard addressing the fair value of all financial instruments is effective, the Board decided to address the concerns of the MBAA through an amendment of Statement 65. The Board decided that Statement 65 should be amended to require that an enterprise engaged in mortgage banking activities classify mortgage-backed securities retained after the securitization of mortgage loans held for sale based on its ability and intent to sell or hold those investments. The Board based its decision on several factors, including the concerns of the MBAA.

11. First, an enterprise engaged in mortgage banking activities frequently does not plan to sell all securities or other retained interests resulting from the securitization of mortgage loans held for sale. The enterprise may retain some of those beneficial interests as long-term investments because they are illiquid and difficult to sell. Those beneficial interests also may be retained because the enterprise decides, for a variety of reasons, to maintain a financial interest in the mortgage loans that it originates.

12. Second, some enterprises do not engage in mortgage banking but their activities are similar to those of a mortgage banking enterprise. Because the receivables they originate, transfer, and service are not mortgages, their activities are not within the scope of Statement 65. Those enterprises, unlike mortgage banking enterprises, are not required to classify securities retained after the securitization of their receivables as trading. They may, instead, choose to classify their retained securities as available-for-sale and, in some cases, held-to-maturity under Statement 115. The Board considered requiring that those enterprises classify securities retained after securitizing nonmortgage receivables as

trading. While that approach would result in greater consistency among enterprises engaged in similar activities, it would require that the scope of this project be expanded significantly. The Board decided against that approach and chose, instead, to amend Statement 65. This approach provides a "level playing field" among enterprises engaged in similar activities while addressing only mortgage banking activities at this time.

13. Third, allowing an enterprise to classify retained securities based on its ability and intent to sell or hold those investments is consistent with the approach in Statement 115. While Statement 115 restricts the ability to classify debt securities as held-to-maturity, it permits an enterprise to choose the appropriate classification based on the enterprise's ability and intent to sell or hold the securities. This Statement allows an enterprise engaged in mortgage banking activities an opportunity to choose the appropriate classification for its retained securities, rather than requiring a trading classification in all cases.

14. In April 1998, the Board issued an Exposure Draft, Accounting for Mortgage-Backed Securities and Certain Other Interests Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise, for a 45-day comment period. Twenty-five organizations and individuals responded to the Exposure Draft. In August 1998, the Board discussed the issues raised in the comment letters in a public Board meeting. The Board concluded that it could reach an informed decision on the basis of existing information without a public hearing.

The Approach in This Statement

15. The Exposure Draft proposed that an enterprise decide whether securities and other beneficial interests that are retained after the securitization of mortgage loans held for sale would, themselves, be held for sale to determine their proper classification. Retained securities that the enterprise holds for sale would have been classified in the trading category, with changes in their fair value recognized currently in earnings. Other retained non-security beneficial interests that the enterprise holds for sale would have been accounted for like securities and also classified as trading. The Board reasoned that a mortgage banking enterprise should use the same criteria to identify retained securities intended to be sold as it uses to identify loans intended to be sold. That approach would

primarily ensure that losses on retained securities and other beneficial interests intended to be sold would be recognized currently in earnings.

Accounting for Retained Securities

16. Many respondents commented that the approach in the Exposure Draft was complex and did not completely level the playing field between a mortgage banking enterprise and a nonmortgage banking enterprise engaged in securitization activities. Those respondents indicated that the accounting for securities retained after the securitization of mortgage loans should be the same as the accounting for securities retained after the securitization of other types of assets. The Board agreed with those respondents and decided to require that retained securities be accounted for in accordance with Statement 115.

17. The Board was concerned that because the term trading is not defined precisely in Statement 115, a mortgage banking enterprise could avoid a trading classification for retained securities it had committed to sell. That might occur because the settlement periods for the retained securities of a mortgage banking enterprise may be longer than the typical settlement periods for other types of securities classified as trading in paragraph 12(a) of Statement 115. The Board decided to require a trading classification for any retained securities that a mortgage banking enterprise commits to sell before or during the securitization process.

Accounting for Other Beneficial Interests

18. Statement 115's amendment of Statement 65 addressed only the accounting for securities that are retained as beneficial interests. The Exposure Draft proposed that retained non-security interests that are held for sale also be classified as trading. Several respondents to the Exposure Draft observed that paragraph 4 of Statement 65 provides applicable guidance for those other beneficial interests and that other enterprises that securitize loans are not required to classify non-security interests as trading. Because the objective of this project was to conform, as nearly as possible, the accounting for all securitizations of loans, the Board agreed and deleted that requirement. This Statement also does not address the accounting for other beneficial interests that are not held for sale. The Board observes that paragraph 6 of Statement 65 provides applicable guidance. Some of those other retained beneficial interests, however, are subject to the provisions of paragraph 14 of Statement

125 and, therefore, must be measured like investments in debt securities classified as available-for-sale or trading under Statement 115.

Classifying Retained Securities as Held-to-Maturity

19. The Board considered restricting the potential categories to trading or available-for-sale for retained securities but decided that that restriction was unjustified. Some observed that permitting an enterprise engaged in mortgage banking activities to classify retained securities as held-to-maturity was undesirable and incompatible with the Board's project to consider measuring all financial instruments at fair value. However, others observed that non-mortgage banking enterprises may choose to classify debt securities as held-to-maturity if all of the necessary provisions of Statement 115 are met. The Board decided that it is beyond the scope of this Statement to reconsider whether Statement 115 should continue to permit historical cost accounting for some securities. Therefore, the Board decided to permit an enterprise engaged in mortgage banking activities to apply the same intent-based accounting that is applied by other enterprises. Therefore, any sales or transfers of retained securities that are classified as held-to-maturity for reasons other than those in paragraphs 8 and 11 of Statement 115 would call into question an enterprise's ability and intent to hold other debt securities to maturity in the future.

20. The Board expects that many mortgage-backed securities retained after the securitization of mortgage loans held for sale would not be classified as held-to-maturity under Statement 115, as amended by Statement 125. Specifically, the Board notes that paragraph 7 of Statement 115 was amended by Statement 125 to require that "a security may not be classified as held-to-maturity if that security can contractually be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment." Likewise, paragraph 14 of Statement 125 requires that "interest-only strips, loans, other receivables, or retained interests in securitizations that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115, as amended by this Statement". However, retained beneficial interests that meet the definition of a derivative or that contain embedded derivative instruments must be accounted for in accordance with Statement 133 upon its adoption. Paragraph 14 of Statement 133 provides an exception for certain interest-only and principal-only strips.

Transition

21. The Board decided to permit an enterprise a one-time opportunity to reclassify mortgage-backed securities and other beneficial interests from the trading category, without regard to the restriction in paragraph 15 of Statement 115. That opportunity is available only on the date that this Statement is initially applied. Transfers from the trading category that result from implementing this Statement should be accounted for in accordance with paragraph 15(a) of Statement 115, that is, the unrealized gain or loss at the date of transfer will have already been recognized in earnings and should not be reversed. While this Statement does not address the accounting for other retained beneficial interests, some mortgage banking enterprises may have classified all of the interests that were measured like securities in accordance with paragraph 14 of Statement 125 as trading. Accordingly, some of those other retained beneficial interests may be eligible for transfer into the available-for-sale category when implementing this Statement. An enterprise engaged in mortgage banking activities often holds other securities unrelated to those retained after the securitization of mortgage loans previously held for sale by that enterprise. Statement 65 did not require that those securities be classified as trading, and they should already be classified in one of the three categories required by Statement 115. Therefore, the transition provisions of this Statement do not apply to those investments.

Footnotes

FAS134, Footnote 1–Mortgage-backed securities and other beneficial interests may be reclassified from the trading category when initially applying this Statement without regard for the provisions in paragraph 15 of Statement 115, which states that "given the nature of a trading security, transfers into or from the trading category . . . should be rare."

FASB STATEMENT NO. 140 ON SECURITISATION:

ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES-A REPLACEMENT OF FASB STATEMENT NO. 125 (ISSUED 9/00)

Summary

This Statement replaces FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* It revises the standards for accounting for securitizations and other transfers of financial assets and collateral and requires certain disclosures, but it carries over most of Statement 125's provisions without reconsideration.

This Statement provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. Those standards are based on consistent application of a *financial-components approach* that focuses on control. Under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. This Statement provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

A transfer of financial assets in which the transferor surrenders control over those assets is accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

a) The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

b) Each transferee (or, if the transferee is a qualifying special-purpose entity (SPE), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor.

c) The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call.

This Statement requires that liabilities and derivatives incurred or obtained by transferors as part of a transfer of financial assets be initially measured at fair value, if practicable. It also requires that servicing assets and other retained interests in the transferred assets be measured by allocating the previous carrying amount between the assets sold, if any, and retained interests, if any, based on their relative fair values at the date of the transfer.

This Statement requires that servicing assets and liabilities be subsequently measured by (a) amortization in proportion to and over the period of estimated net servicing income or loss and (b) assessment for asset impairment or increased obligation based on their fair values.

This Statement requires that a liability be derecognized if and only if either (a) the debtor pays the creditor and is relieved of its obligation for the liability or (b) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. Therefore, a liability is not considered extinguished by an in-substance defeasance.

This Statement provides implementation guidance for assessing isolation of transferred assets, conditions that constrain a transferee, conditions for an entity to be a qualifying SPE, accounting for transfers of partial interests, measurement of retained interests, servicing of financial assets, securitizations, transfers of sales-type and direct financing lease receivables, securities lending transactions, repurchase agreements including "dollar rolls," "wash sales," loan syndications and participations, risk participations in banker's acceptances, factoring arrangements, transfers of receivables with recourse, and extinguishments of liabilities. This Statement also provides guidance about whether a transferor has retained effective control over assets transferred to qualifying SPEs through removal-of-accounts provisions, liquidation provisions, or other arrangements.

This Statement requires a debtor to (a) reclassify financial assets pledged as collateral and report those assets in its statement of financial position separately from other assets not so encumbered if the secured party has the right by contract or custom to sell or repledge the collateral and (b) disclose assets pledged as collateral that have not been reclassified and separately reported in the statement of financial position. This Statement also requires a secured party to disclose information about collateral that it has accepted and is permitted by contractor custom to sell or repledge. The required disclosure includes the fair value at the end of the period of that collateral, and of the portion of that collateral that it has sold or repledged, and information about the sources and uses of that collateral.

This Statement requires an entity that has securitized financial assets to disclose information about accounting policies, volume, cash flows, key assumptions made in determining fair values of retained interests, and sensitivity of those fair values to changes in key assumptions. It also requires that entities that securitize assets disclose for the securitized assets and any other financial assets it manages together with them (a) the total principal amount outstanding, the portion that has been derecognized, and the portion that continues to be recognized in each category reported in the statement of financial position, at the end of the period; (b) delinquencies at the end of the period; and (c) credit losses during the period.

In addition to replacing Statement 125 and rescinding FASB Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125,* this Statement carries forward the actions taken by Statement 125. Statement 125 superseded FASB Statements No. 76, *Extinguishment of Debt,* and No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse.* Statement 125 amended FASB Statement No. 115, *Accounting for Certain*

Investments in Debt and Equity Securities, to clarify that a debt security may not be classified as held-to-maturity if it can be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. Statement 125 amended and extended to all servicing assets and liabilities the accounting standards for mortgage servicing rights now in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities,* and superseded FASB Statement No. 122, *Accounting for Mortgage Servicing Rights*. Statement 125 also superseded FASB Technical Bulletins No. 84-4, *In-Substance Defeasance of Debt,* and No. 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs),* and amended FASB Technical Bulletin No. 87-3, *Accounting for Mortgage Servicing Fees and Rights.*

Statement 125 was effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996, and on or before March 31, 2001, except for certain provisions. Statement 127 deferred until December 31, 1997, the effective date (a) of paragraph 15 of Statement 125 and (b) for repurchase agreement, dollar-roll, securities lending, and similar transactions, of paragraphs 9-12 and 237(b) of Statement 125.

This Statement is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001. This Statement is effective for recognition and reclassification of collateral and for disclosures relating to securitization transactions and collateral for fiscal years ending after December 15, 2000. Disclosures about securitization and collateral accepted need not be reported for periods ending on or before December 15, 2000, for which financial statements are presented for comparative purposes.

This Statement is to be applied prospectively with certain exceptions. Other than those exceptions, earlier or retroactive application of its accounting provisions is not permitted.

FASB STATEMENT NO. 156

ACCOUNTING FOR SERVICING OF FINANCIAL ASSETS—AN AMENDMENT OF FASB STATEMENT NO. 140

Summary

This Statement amends FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* with respect to the accounting for separately recognized servicing assets and servicing liabilities. This Statement:

1. Requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in any of the following situations:

A transfer of the servicer's financial assets that meets the requirements for sale accounting

a. A transfer of the servicer's financial assets to a qualifying special-purpose entity in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities and classifies them as either available-for-sale securities or trading securities in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*

b. An acquisition or assumption of an obligation to service a financial asset that does not relate to financial assets of the servicer or its consolidated affiliates.

2. Requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable.

3. Permits an entity to choose either of the following subsequent measurement methods for each class of separately recognized servicing assets and servicing liabilities:

a. *Amortization method*—Amortize servicing assets or servicing liabilities in proportion to and over the period of estimated net servicing income or net servicing loss and assess servicing assets or servicing liabilities for impairment or increased obligation based on fair value at each reporting date.

b. *Fair value measurement method*—Measure servicing assets or servicing liabilities at fair value at each reporting date and report changes in fair value in earnings in the period in which the changes occur.

1. At its initial adoption, permits a one-time reclassification of available-for-sale securities to trading securities by entities with recognized servicing rights, without calling into question the treatment of other available-for-sale securities under Statement 115, provided that the available-for-sale securities are identified in some manner as offsetting the entity's exposure to changes in fair value of servicing assets or servicing liabilities that a servicer elects to subsequently measure at fair value.

2. Requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities.

Reasons for Issuing This Statement

The Board added this project to its agenda because constituents asked the Board to reconsider Statement 140's requirements for accounting for mortgage servicing assets and servicing liabilities. The Board decided to broaden the scope of the project to include all servicing assets and servicing liabilities. Servicing assets and servicing liabilities may be subject to significant interest rate and prepayment risks, and many entities use financial instruments to mitigate those risks. Currently, servicing assets and servicing liabilities are amortized over the expected period of estimated net servicing income or loss and assessed for impairment or increased obligation at each reporting date. The Board acknowledged that the application of the lower of carrying amount or fair value measurement attribute to servicing assets results in asymmetrical recognition of economic events, because it requires recognition of all decreases in fair value but limits recognition of increases in fair value to the original carrying amount.

An entity may use derivative instruments to mitigate the risks inherent in its servicing assets and servicing liabilities. An entity that does not apply hedge accounting to these derivative instruments is exposed to income statement volatility that arises from the use of different measurement attributes for the servicing assets and servicing liabilities and the related derivative instruments. For example, in rising interest rate environments, decreases in the fair value of derivatives are reflected in the income statement, but increases in the fair value of related servicing assets are not reflected in the income statement to the extent that fair value exceeds the amortized carrying amount. Some constituents believe that meeting current hedge accounting criteria is burdensome and unduly restrictive and that the asymmetrical accounting for mortgage servicing assets and servicing liabilities and the related financial instruments used to mitigate the related risks does not appropriately reflect the economics of the hedging techniques employed.

When adding this project to its agenda, the Board also considered the complexity of application of the amortization method, such as the timing and characterization of impairment allowances versus write-downs, as well as the desire to simplify the accounting requirements for servicing assets and servicing liabilities.

How This Statement Improves Financial Reporting

This Statement requires that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable. The Board concluded that fair value is the most relevant measurement attribute for the initial recognition of all servicing assets and servicing liabilities, because it represents the best measure of future cash flows. This Statement permits, but does not require, the subsequent measurement of servicing assets and servicing liabilities at fair value. An entity that uses derivative instruments to mitigate the risks inherent in servicing assets and servicing liabilities is required to account for those derivative instruments at fair value. Under this Statement, an entity can elect subsequent fair value measurement of its servicing assets and servicing liabilities by class, thus simplifying its accounting and providing for income statement recognition of the potential offsetting changes in fair value of the servicing assets, servicing liabilities, and related derivative instruments. An entity that elects to subsequently measure servicing assets and servicing liabilities at fair value is expected to recognize declines in fair value of the servicing assets and servicing liabilities more consistently than by reporting other-than-temporary impairments.

The Board decided to require additional disclosures and separate presentation in the statement of financial position of the carrying amounts of servicing assets and servicing liabilities that an entity elects to subsequently measure at fair value to address concerns about comparability that may result from the use of elective measurement methods.

Effective Date and Transition

An entity should adopt this Statement as of the beginning of its first fiscal year that begins after September 15, 2006. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including interim financial statements, for any period of that fiscal year. The effective date of this Statement is the date an entity adopts the requirements of this Statement.

An entity should apply the requirements for recognition and initial measurement of servicing assets and servicing liabilities prospectively to all transactions after the effective date of this Statement.

An entity may elect to subsequently measure a class of separately recognized servicing assets and servicing liabilities at fair value as of the beginning of any fiscal year, beginning with the fiscal year in which the entity adopts this Statement. An entity that elects to subsequently measure a class of separately recognized servicing assets and servicing liabilities at fair value should apply that election prospectively to all new and existing separately recognized servicing assets and servicing liabilities within those classes that a servicer elects to subsequently measure at fair value. The effect of remeasuring an existing class of separately recognized servicing assets and servicing liabilities at fair value should be reported as a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year and should be separately disclosed.

This Statement permits an entity to reclassify certain available-for-sale securities to trading securities, regardless of the restriction in paragraph 15 of Statement 115, provided that those available-for-sale securities are identified in some manner as offsetting the entity's exposure to changes in fair value of servicing assets or servicing liabilities that a servicer elects to subsequently measure at fair value. This option is available only once, as of the beginning of the fiscal year in which the entity adopts this Statement. Any gains and losses associated with the reclassified securities that are included in accumulated other comprehensive income at the time of the reclassification should be reported as a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year that an entity adopts this Statement. The carrying amount of reclassified securities and the effect of that reclassification on the cumulative-effect adjustment should be separately disclosed.

FASB STATEMENT NO. 166

ACCOUNTING FOR TRANSFERS OF FINANCIAL ASSETS—AN AMENDMENT OF FASB STATEMENT NO. 140

Summary

Why Is the FASB Issuing This Statement and When Will It Be Effective?

The Board's objective in issuing this Statement is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. The Board undertook this project to address (1) practices that have developed since the issuance of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* that are not consistent with the original intent and key requirements of that

Statement and (2) concerns of financial statement users that many of the financial assets (and related obligations) that have been derecognized should continue to be reported in the financial statements of transferors.

This Statement must be applied as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. Earlier application is prohibited. This Statement must be applied to transfers occurring on or after the effective date.

Additionally, on and after the effective date, the concept of a qualifying special-purpose entity is no longer relevant for accounting purposes. Therefore, formerly qualifying special-purpose entities (as defined under previous accounting standards) should be evaluated for consolidation by reporting entities on and after the effective date in accordance with the applicable consolidation guidance. If the evaluation on the effective date results in consolidation, the reporting entity should apply the transition guidance provided in the pronouncement that requires consolidation.

Additionally, the disclosure provisions of this Statement should be applied to transfers that occurred both before and after the effective date of this Statement.

What Is the Scope of This Statement?

This Statement has the same scope as Statement 140. Accordingly, this Statement applies to all entities.

How Will This Statement Change Current Practice?

This Statement removes the concept of a qualifying special-purpose entity from Statement 140 and removes the exception from applying FASB Interpretation No. 46 (revised December 2003) ,*Consolidation of Variable Interest Entities,* to qualifying special-purpose entities.

This Statement clarifies that the objective of paragraph 9 of Statement 140 is to determine whether a transferor and all of the entities included in the transferor's financial statements being presented have surrendered control over transferred financial assets. That determination must consider the transferor's continuing involvements in the transferred financial asset, including all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer, even if they were not entered into at the time of the transfer. This Statement modifies the financial-components approach used in Statement 140 and limits the circumstances in which a financial asset, or portion of a financial asset, should be derecognized when the transferor has not transferred the entire original financial asset to an entity that is not consolidated with the transferor in the financial statements being presented and/or when the transferor has continuing involvement with the transferred financial asset.

This Statement defines the term *participating interest* to establish specific conditions for reporting a transfer of a portion of a financial asset as a sale. If the transfer does not meet those conditions, a transferor should account for the transfer as a sale only if it transfers an entire financial asset or a group of entire financial assets and surrenders control over the entire transferred asset(s) in accordance with the conditions in paragraph 9 of Statement 140, as amended by this Statement.

The special provisions in Statement 140 and FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities,* for guaranteed mortgage securitizations are removed to require those securitizations to be treated the same as any other transfer of financial assets within the scope of Statement 140, as amended by this Statement. If such a transfer does not meet the requirements for sale accounting, the securitized mortgage loans should continue to be classified as loans in the transferor's statement of financial position.

This Statement requires that a transferor recognize and initially measure at fair value all assets obtained (including a transferor's beneficial interest) and liabilities incurred as a result of a transfer of financial assets accounted for as a sale.

Enhanced disclosures are required to provide financial statement users with greater transparency about transfers of financial assets and a transferor's continuing involvement with transferred financial assets.

How Will This Statement Improve Financial Reporting?

This Statement improves financial reporting by eliminating (1) the exceptions for qualifying special-purpose entities from the consolidation guidance and (2) the exception that permitted sale accounting for certain mortgage securitizations when a transferor has not surrendered control over the transferred financial assets. In addition, comparability and consistency in accounting for transferred financial assets will be improved through clarifications of the requirements for isolation and limitations on portions of financial assets that are eligible for sale accounting.

This Statement enhances the information provided to financial statement users to provide greater transparency about transfers of financial assets and a transferor's continuing involvement, if any, with transferred financial assets. Under this Statement, many types of transferred financial assets that would have been derecognized previously are no longer eligible for derecognition. This Statement requires enhanced disclosures about the risks that a transferor continues to be exposed to because of its continuing involvement in transferred financial assets.

This Statement also clarifies and improves certain provisions in Statement 140 that have resulted in inconsistencies in the application of the principles on which that Statement is based.

What Is the Effect of This Statement on Convergence with International Financial Reporting Standards?

The International Accounting Standards Board (IASB) has projects on its agenda to develop new standards on derecognition and consolidation. The IASB issued two related Exposure Drafts—*Consolidated Financial Statements,* and *Derecognition*—in December 2008 and March 2009, respectively.

This Statement is designed to provide a short-term solution to address inconsistencies in practice in the context of the existing concepts in Statement 140. In the short term, this project improves convergence by eliminating the concept of a qualifying special-purpose entity, which does not exist in International Financial Reporting Standards, and by limiting the portions of financial assets that are eligible for derecognition. This project also incorporates certain of the disclosures currently required by IFRS 7, *Financial Instruments: Disclosures*. Ultimately, the two Boards will seek to issue a converged derecognition standard.

Taxation Aspects of Securitisation:

Whenever a securitisation transaction takes place, the parties involved would be anxious to know what is the tax component they have to bear. As in any case, the objective of their intention is to know whether any tax neutrality is possible or not, which in other words means, they want to ensure that the securitisation transaction does not entail any additional tax burden or any accelerated form of tax other than would have been the case had the transaction not taken place. However, securitisation transaction involves some amount of tax and it is in the interest of the Originator to know the amount of tax in advance so that he can compare the amount of tax he has to pay with the amount of benefits he is going to receive because of the transaction. The same is true with respect to the other parties of the securitisation transaction- the SPV and the investors. They also would be eager to know the tax implications of the securitisation transaction. It is imperative that the rating agency also knows the tax burden because the rating of the issuer depends on the amount of tax he has cough out. If there is any unexpected change in the rate or amount of tax, the rating of the bonds issued by the issuer also gets affected. In fact, in many cases, the rating agency insists for some kind of indemnity from the Originator to protect himself from any kind of unforeseen tax changes.

Now let us examine the taxation aspect of securitisation transaction with respect to all the three parties involved.

a) Originator

b) Special Purpose Vechicle

c) Investor

Taxation issues with respect to the Originator:

Whenever there is a securitisation transaction, the first question that comes up with respect to the Originator's tax status is

1) Whether the transfer of receivables constitute sale?

2) Whether the sale results in any kind of profit/loss?

3) Whether the transfer will also entail any kind of indirect tax like VAT?

Apart from these questions, the other questions that may arise are:

1) What happens if any bad debts arise from the receivable pool that has been securitised?

2) If there are any servicing arrangements with the receiver, whether the service fee paid to him involves any service tax or VAT?

3) If the issuer is in another country, is there any tax incidence offshore?

4) Will there be any capital gains tax for the Originator?

5) What about the taxation of any credit enhancement provided to the issuer which may be in the form of subordinate loans or guarantee arrangements?

6) What is the impact of the transfer pricing on the entire transaction?

Taxation issues relating to the SPV:

1) What is the tax implication on the income generated from the receivables?

2) What about the expenses incurred by the SPV with relation to issuing of securities?

3) What happens if the Originator is offshore?

4) What happens if the transaction has any tax implication in some other country or territory?

5) Are there any TDS component involved on any receivable incomes of the issuer?

6) Are there any TDS component involved on the interest on securities issued by the issuer?

All these questions can be answered only when they are analysed in the light of the circumstances that exist in the transaction like the nature of the assets being securitised; the legal and tax laws of the Originator and the Issuer's country if they are different. If the transaction is a multi-jurisdictional one, then it involves the laws of many countries and makes the taxation issue more complex.

Continuing the above discussion, let us now understand what the tax laws say with respect to each party involved in the securitisation transaction:

(14) TAXATION OF SECURITISATION

Provisions of Income Tax Act, 1963 relating to Securitisation:

Finance Act, 2013 made the following amendments with respect to Securitisation taxation from the year 2013. The three important Sections which have been amended are:

1. Section 115TA
2. Section 115TB
3. Section 115TC

CHAPTER XII-EA

SPECIAL PROVISIONS RELATING TO TAX ON DISTRIBUTED INCOME BY SECURITISATION TRUSTS

Tax on distributed income to investors.

115TA. (1) Notwithstanding anything contained in any other provisions of the Act, any amount of income distributed by the securitisation trust to its investors shall be chargeable to tax and such securitisation trust shall be liable to pay additional income-tax on such distributed income at the rate of-

(i) twenty-five per cent, on income distributed to any person being an individual or a Hindu undivided family;

(ii) thirty per cent, on income distributed to any other person:

Provided that nothing contained in this sub-section shall apply in respect of any income distributed by the securitisation trust to any person in whose case income, irrespective of its nature and source, is not chargeable to tax under the Act.

(2) The person responsible for making payment of the income distributed by the securitisation trust shall be liable to pay tax to the credit of the Central Government within fourteen days from the date of distribution or payment of such income, whichever is earlier.

(3) The person responsible for making payment of the income distributed by the securitisation trust shall, on or before the 15th day of September in each year, furnish to the prescribed

income-tax authority, a statement in the prescribed form and verified in the prescribed manner, giving the details of the amount of income distributed to investors during the previous year, the tax paid thereon and such other relevant details, as may be prescribed.

(4) No deduction under any other provisions of this Act shall be allowed to the securitisation trust in respect of the income which has been charged to tax under subsection (l).

Interest payable for non-payment of tax.

115TB. Where the person responsible for making payment of the income distributed by the securitisation trust and the securitisation trust fails to pay the whole or any part of the tax referred to in sub-section (l) of section 115TA, within the time allowed under sub-section (2) of that section, he or it shall be liable to pay simple interest at the rate of one per cent, every month or part thereof on the amount of such tax for the period beginning on the date immediately after the last date on which such tax was payable and ending with the date on which the tax is actually paid.

Securitisation trust to be assessee in default.

115TC. If any person responsible for making payment of the income distributed by the securitisation trust and the securitisation trust does not pay tax, as referred to in sub-section (l) of section 115TA, then, he or it shall be deemed to be an assessee in default in respect of the amount of tax payable by him or it and all the provisions of this Act for the collection and recovery of income-tax shall apply.

Explanation.-For the purposes of this Chapter,-

(a) "investor" means a person who is holder of any securitised debt instrument or securities issued by the securitisation trust;

(b) "securities" means debt securities issued by a Special Purpose Vehicle as referred to in the guidelines on securitisation of standard assets issued by the Reserve Bank of India;

(c) "securitised debt instrument" shall have the same meaning as assigned to it in clause (s) of sub-regulation (1) of regulation 2 of the Securities and Exchange Board of India (Public Offer and Listing of Securitised Debt Instruments) Regulations, 2008 made under the Securities and

Exchange Board of India Act, 1992 and the Securities Contracts (Regulation) Act, 1956; ***(15 of 1992) (42 of 1956.)***

(d) "securitisation trust" means a trust, being a-

(i) "special purpose distinct entity" as defined in clause (u) of sub-regulation (1) of regulation 2 of the Securities and Exchange Board of India (Public Offer and Listing of Securitised Debt Instruments) Regulations, 2008 made under the Securities and Exchange Board of India Act, 1992 and the Securities Contracts (Regulation) Act, 1956, and regulated under the said regulations; or ***(15 of 1992) (42 of 1956.)***

(ii) "Special Purpose Vehicle" as defined in, and regulated by, the guidelines on securitisation of standard assets issued by the Reserve Bank of India,

which fulfils such conditions, as may be prescribed.',

(15) IMPACT OF VARIOUS LEGISLATIONS ON SECURITISATION TRANSACTIONS:

Briefly, some of the Legislations / Enactments involved and their impact on securitisation transactions are as follow.

The Companies Act 1956:

Since the SPV can be structured as a limited company, its incorporation, management and constitution would be governed by the Companies Act 1956.

The Companies Act 1956 will affect the SPV in the following matters:

- Framing the Memorandum and Articles of Associates of the SPV and formation of SPV as a Limited Company.
- Management of affairs viz. Board of Directors, Managing Director's appointment, Borrowing Powers/delegation of powers for recovery of receivables etc.
- Share Capital Structure.
- Issuance of Bonds/Debentures etc. to investors (whether by public issue or private placement) and servicing the investors.
- Winding up of SPV voluntarily after debts of all investors are satisfied and where the SPV has also received all the due receivables.

The Indian Stamp Act 1899 and other applicable State Stamp Acts.

The incidence of Stamp Duty arises on the following:

- Stamping of the Memorandum and Articles of Association of the SPV.
- Stamping of the Deed of Assignment of assets/receivables by the Originator to the SPV
- Stamping of the Trust Deed whereby SPV gets a Trust status for the benefit of investors at large.
- Stamping of the irrevocable Power of Attorney to be executed in favour of SPV by Originator entitling SPV to recover debts.
- Stamp duty on instruments to be issued to investors by the SPV.

The Transfer of Property Act 1882:

Securitisation attracts the provisions of chapter VIII Sections 130 – 137 of the Transfer of Property Act 1882, which deal with transfers of actionable claims. The said provisions relate to

- Execution of a proper Instrument for assignment of actionable claims.
- Notifying the debtors.

The Act does not, however, provide for transfer of mortgages in the event of securitisation.

Indian Trusts Act 1882:

Since the SPV would act as a Trustee for the benefit of the investors, the following provisions of the Indian Trusts Act 1882 would be attracted to such SPV.

- Execution of a non-testamentary instrument for creation of a Trust (where there is assignment of interest in mortgage property i.e. assets/receivables secured by mortgage of immovable property).
- Duties and liabilities of the SPV (as Trustee).
- Rights and Powers of SPV (as Trustee).

SEBI (Mutual Funds) Regulations, 1996:

The provisions of SEBI (Mutual Funds) Regulations, 1996 that would apply in case of securitisation transaction are with respect

- Registration of SPV as intermediary for securitisation transactions

SEBI (Public Offer and Listing of Debt Instruments) Regulations, 2008

The Income Tax Act 1961:

The incidence of Income tax on the following would need examination

- Assignment of assets/receivables by Originator to SPV.
- Receipt of assets/receivables by SPV
- Income earnings of SPV
- Interest payments (TDS) on instruments issued to investors by SPV.

The Registration Act:

The current registration charges on creation and/or declaration of interest in immovable property render the securitisation transaction economically unviable. Individual State Governments may be approached to consider remission of registration charges on securitisation transactions.

What is a true sale in Securitisation?

In all securitisations where the originator purports to effect an outright transfer of the securitisation assets, it is essential to consider whether the transfer is a "true sale" or whether it might be re-categorised by a court as a mortgage by the originator in favour of the purchaser/ mortgagee. Whilst the parties to a transaction may have framed it as an outright transfer, the courts will categorise a given transaction according to the legal effect of the rights created, and not upon the intentions of the parties as to the categorisation of the contract, or the labels they have used. The risk is that, in the event of re-categorisation, the SPV would be in a very different position a propos the securitised assets: the assets would continue to be assets of the originator available in its insolvency, but subject to the SPV's security interest (whatever form that might take, and whatever the rights and remedies it creates in favour of the SPV as mortgagee); and, moreover, such security interest would be void against a liquidator, administrator or creditor of the originator for failure to comply with Section 395 of the Companies Act 1985. Section 395 relates to registration of certain types of security interest at Companies House, and particulars of the securitisation "sale" will not have been filed as there is no provision for the registration of absolute transfers of assets.

The relevance of the risk is obvious in the case of all cash securitisation transactions because, whilst relying upon an outright transfer of assets to an SPV, they have as their net effect the raising of non-recourse finance for the originator, albeit via the medium of the SPV and notwithstanding that the transaction might have been partially or totally motivated by other such considerations such as capital adequacy rules.

In terms of the differences between a sale and a mortgage, the following points are noteworthy:

Right of redemption: In a transaction of sale the vendor is not entitled to get back the subject-matter of the sale by returning to the purchaser the money that has passed between them. In the case of a mortgage or charge, the mortgagor is entitled, until he has been foreclosed, to get back the subject-matter of the mortgage or charge by returning to the mortgagee the money that has passed between them.

Positive equity: If the mortgagee realises the subject-matter of the mortgage for a sum more than sufficient to repay him, with interest and the costs, the money that has passed between him and the mortgagor he has to account to the mortgagor for the surplus. If the purchaser sells the subject-matter of the purchase, and realises a profit, of course he has not got to account to the vendor for the profit.

Negative equity: If the mortgagee realises the mortgaged property for a sum that is insufficient to repay him the money that [has been] paid to the mortgagor, together with interest and costs, then the mortgagee is entitled to recover from the mortgagor the balance of the money … If the purchaser were to resell the purchased property at a price which was insufficient to recoup him the money that he had paid to the vendor … he would not be entitled to recover the balance from the vendor."

However, these guidelines are not exhaustive as they do not take into account all such differences: for example, under a mortgage, a mortgagor will have to pay an interest rate whereas a seller does not have to make any analogous ongoing payments after the transaction is concluded; and the mortgagee under a mortgage does not ordinarily have the ability to deal in the asset whereas a buyer should be free to sell of mortgage the asset as its owner. Moreover, as well as recognising that other distinguishing factors do exist, the courts have recognised that the guidelines do not themselves definitively distinguish between a sale and a mortgage.

The most popular securitisation transaction undertaken is 'true sale'. In a traditional "true sale" structure, the originator sells a pool of assets to the SPV and receives the proceeds from the issue of notes by the SPV as the purchase price for the assets acquired. True sale is indicted by complete assignment of receivables whereupon the assignee enjoys all the rights, titles, and interest over the same to the exclusion of any other person and is entitled to deal with these receivables (which are its property) as it so desires including selling, or placing encumbrances over the same. Moreover, the assignee should be in a position to recover the receivables from the obligor on its own and without relying upon the seller. In India, the criteria for determining a true sale have been evolved on the basis of case law. It provides that the assignor continues to have control over the assets or features implying thereby that the entire risk and reward in respect of the transaction would not arise to the assignee following the transfer.

True sale securitisations have to satisfy very strict criteria. The risk connected with the securities must only result from the underlying pool of re-ceivables and not from other sources, for instance the insolvency risk of the selling bank or the issuing companies. In addition, the receivables must be legally separated from the selling bank. This is achieved by an originator selling receivables to a so-called SPV, set up specifically for the purpose of purchasing these receivables. The originator remains responsible for the administration and servicing of the sold portfolio. All future payments made under these receivables, which continue to be paid to the origina-tor, are due to the SPV as buyer. The originator receives liquidity from the payment of the purchase price by the SPV and has transferred the credit risks to the special-purpose vehicle. The special-purpose vehicle refinances the purchase price to be paid for the receivables from the issue proceeds obtained in the capital market.

What does the RBI say on true sale criteria?

The securitisation guidelines issued by RBI on August 21, 2012 lay down certain 'true sale' criteria that must be met in respect of direct assignments. The sale will qualify as a true sale only if:

- the assignment results in the immediate legal separation of the selling bank from the assets being sold;
- the buyer has an unfettered right to transfer, pledge, sell or otherwise dispose off the assets acquired;
- the selling bank has no economic interest in the assets following a sale;
- the purchasing bank has no recourse to the selling bank for any expenses or losses except those specifically permitted;
- other than on account of breach of a representation or warranty, the seller has no obligation to repurchase or fund the assets sold; and
- there are no 'clean-up calls' or other similar obligations of the seller in respect of the transferred assets.

Now let us study these guidelines in detail:

For enabling the transferred assets to be removed from the balance sheet of the originator in a securitisation structure, the isolation of assets or 'true sale' from the originator to the SPV is an essential prerequisite. In case the assets are transferred to the SPV by the originator in full compliance with all the conditions of true sale given below, the transfer would be treated as a 'true sale' and originator will not be required to maintain any capital against the value of assets so transferred from the date of such transfer. The effective date of such transfer should be expressly indicated in the subsisting agreement. In the event of the transferred assets not meeting the "true-sale" criteria the assets would be deemed to be on the balance sheet of the originator and accordingly the originator would be required to maintain capital for those assets. The criteria of true-sale that have been prescribed below are illustrative but not exhaustive.

The criteria for "True Sale" of assets

1. The sale should result in immediate legal separation of the originator from the assets which are sold to the new owner viz. the SPV. The assets should stand completely isolated from the

originator, after its transfer to the SPV, i.e., put beyond the originator’s as well as their creditors' reach, even in the event of bankruptcy of the originator.

2. The originator should effectively transfer all risks/ rewards and rights/ obligations pertaining to the asset and shall not hold any beneficial interest in the asset after its sale to the SPV. An agreement entitling the originator to any surplus income on the securitised assets at the end of the life of the securities issued by the SPV would not be deemed as a violation of the true sale criteria. The SPV should obtain the unfettered right to pledge, sell, transfer or exchange or otherwise dispose of the assets free of any restraining condition.
3. The originator shall not have any economic interest in the assets after its sale and the SPV shall have no recourse to the originator for any expenses or losses except those specifically permitted under these guidelines.
4. There shall be no obligation on the originator to re-purchase or fund the re-payment of the asset or any part of it or substitute assets held by SPV or provide additional assets to the SPV at any time except those arising out of breach of warranties or representations made at the time of sale. The originator should be able to demonstrate that a notice to this effect has been given to the SPV and that the SPV has acknowledged the absence of such obligation.
5. An option to repurchase fully performing assets at the end of the securitisation scheme where residual value of such assets has, in aggregate, fallen to less than 10% of the original amount sold to the SPV ("clean up calls") as allowed vide paragraph 10 can be retained by the originator.
6. The originator should be able to demonstrate that it has taken all reasonable precautions to ensure that it is not obliged, nor will feel impelled, to support any losses suffered by the scheme or investors.
7. The sale shall be only on cash basis and the consideration shall be received not later than at the time of transfer of assets to the SPV. The sale consideration should be market-based and arrived at in a transparent manner on an arm's length basis.
8. Provision of certain services (such as credit enhancement, liquidity facility, underwriting, asset-servicing, etc.) and assumption of consequent risks/ obligations by the originators as specifically allowed in these guidelines would not detract from the 'true sale' nature of the transaction, provided such service obligations do not entail any residual credit risk on the assets securitized or any additional liability for them beyond the contractual performance obligations in respect of such services.
9. An opinion from the originating bank's Legal Counsel should be kept on record signifying that: (i) all rights, titles, interests and benefits in the assets have been transferred to SPV; (ii)

originator is not liable to investors in any way with regard to these assets other than liability for certain permitted contractual obligations for example, credit enhancement/ liquidity facility; and (iii) creditors of the originator do not have any right in any way with regard to these assets even in case of bankruptcy of the originator.

10. Any re-schedulement, restructuring or re-negotiation of the terms of the underlying agreement/s effected after the transfer of assets to the SPV, shall be binding on the SPV and not on the originator and shall be done only with the express consent of the investors, providers of credit enhancement and other service providers. This should be expressly provided in the sale transaction documents.
11. The transfer of assets from originator must not contravene the terms and conditions of any underlying agreement governing the assets and all necessary consents from obligors (including from third parties, where necessary) should have been obtained.
12. In case the originator also provides servicing of assets after securitisation, under an agreement with the SPV, and the payments/repayments from the borrowers are routed through it, it shall be under no obligation to remit funds to the SPV/investors unless and until these are received from the borrowers.
13. The originator should not be under any obligation to purchase the securities issued by the SPV and should not subscribe to their primary issue. The originator may, however, purchase at market price only senior securities issued by the SPV if these are at least 'investment grade', for investment purposes. Such purchase, along with the securities that may devolve on account of underwriting commitments, should not exceed 10% of the original amount of the issue.
14. The originator shall not indulge in market-making or dealing in the securities issued by the SPV.
15. The securities issued by the SPV shall not have any put options. The securities may have a call option to address the pre-payment risk on the underlying assets.

Elements of True Sale

The various elements resulting in a true sale are not found in any single source but rather have developed over time through case law, scholarly writings and industry practice. It is not necessary that all the elements which I am listing out below be present in a given transfer for an attorney to say - or a judge to determine - that a transfer is a true sale. However, the more undiluted true sale factors that are present in a given transaction, the more likely a law firm will opine - or a judge will determine - that such transaction is a true sale.

The following is a list of what I consider the principal true sale factors.

1. **Recourse**: Probably the most important true sale factor is the absence of recourse by the transferee to the transferor for non-payment of the transferred asset. As with any sale, however, recourse is permitted for the seller's breach of standard clauses, warranties and covenants regarding the transferred assets, including in the case of an accounts receivable transfer, the failure to keep the accounts free of dilution. Thus, the type of recourse that is not permitted in a true sale is recourse for non-payment due to the account debtor's credit risk.

2. **Intent:** The other important aspect is the intention of the parties involved to accomplish a true sale. However, if the intention of the parties involved is a loan rather than a sale, then it must be expressed in the transaction documents and also it must be included in communications between the parties and in each party's records. The substance – rather than the form – of the transaction is what is important. Thus, documentation that describes a transfer as a sale but that also contains an indication of a loan will not be helpful to support a true sale.

3. **Identification of the Transferred Assets; Administration as a Sale**: This is yet another important element in a true sale transaction. You should identify what you want to sell and you can't sell what you can't identify, and in the context of financial assets, that applies to proceeds as well. Thus, accounts receivable transferred in a true sale must be identified with specificity, and if a party other than the transferee is servicing the accounts receivable, the collections should be segregated in a special collection account rather than mixing them up with the servicer's other funds. Notification of the transfer to the account debtors will also favour true sale.

4. **Amount Paid to Seller in Relation to Fair Value:** The purchase of any asset ostensibly reflects that asset's fair value - otherwise, the seller would not be willing to part with it. As a result, payment of less than fair value for an asset could be evidence that something other than a true sale was intended. The fair value of an account receivable might be calculated this way:

(a) the net face amount of the invoice (i.e., the gross invoice amount less any adjustments or allowances given by the seller and less any discounts available to the account debtor for early payment)

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(b) the purchaser's per annum cost of funds plus a reasonable margin, pro-rated over a reasonably expected number of days until payment of the account.

To reflect the purchaser's permissible recourse against the seller, a dilution reserve may be netted against the purchase price paid, but such reserve must be based on an identifiable formula that bears a reasonable relationship to historical dilution. In addition, any collections by the purchaser reflecting less dilution than what was reserved for must be remitted to the seller periodically. Purchase price reductions other than those set forth above or that are not identified with specificity could be viewed as both indicia of a loan and impermissible recourse.

5. **Irrevocability**: In a true sale, the risks and benefits of ownership must pass to the transferee upon closing, and those risks and benefits cannot then be reallocated. Lack of irrevocability may be evidenced, among other things, by an agreement that the transferee will receive a specified rate of return on its investment when in fact fluctuations in the dates on which accounts receivable are paid mean that a specified rate of return cannot be guaranteed. Lack of irrevocability may also be evidenced by an agreement to terminate a transaction at a given time and to re-convey any unpaid accounts to the seller in exchange for the outstanding balance of the accounts.

From the above guidelines, we have understood that a true sale is one which includes direct sale, assignment and any other form of transfer of asset. However, it does not include:

a) Bills rediscounted
b) outright transfer of loan accounts to the other financial entities at the instance of the borrower
c) sale of bonds other than those in the nature of advance

Now let us examine some case laws relating to securitisation to understand what the courts say about true sale:

Risk of Re-Characterisation

While the character of the transfer may seem straightforward, some of the other commercial requirements of the transaction may result in doubt being cast on the validity and effectiveness of the transfer. For instance, where the transaction has certain characteristics, such as the originator receiving a servicing fee calculated by reference to "profit" in the receivables pool and has a right to re-purchase receivables to end the securitisation, it could be argued that the transfer could be viewed as a loan with the granting of security rather than a sale. As the security interest would not have been registered, it would be void against third party creditors or a liquidator of the originator.

The English courts have however been reluctant to re-characterise a transaction expressed as a sale as something other than a sale, except where the transaction is clearly a sham. The questions a court will consider were set out in ***Re: George Inglefiel*** and were considered and applied by the English Court of Appeal in ***Welsh Development Agency v Export Finance Co. Ltd*** and ***Orion Finance Limited v Crown Financial Management Ltd*** as follows:

i. Is the intention of the parties (as expressed by the language in the sale agreement) consistent with a transfer by way of sale, as opposed to an assignment by way of security?

ii. Is the transfer pursuant to the sale agreement in consideration of the payment of a purchase price *or the provision of funds for a term certain*?

iii. Does the originator have the right to re-acquire any of the receivables sold by it by repaying the purchase price to the SPV?

iv. Does the SPV have any obligation to account to the originator for any profit made on any disposition by it of property acquired pursuant to the sale agreement?

v. In a trust situation, does the trust deed provide for the beneficiaries of the trust (the investors) to have a right of recourse against the originator if the trustee disposes of the receivables for an amount less than the price paid for them?

The courts have been clear that the failure of an agreement to reflect one or more of the features characteristic of a sale would not in itself result in the transfer being treated as something other than a sale. The courts will look at these characteristics in the context of the transaction as a whole.

It must be noted at this point that based on our knowledge of a secured credit transaction, there is a clear but thin line between the mode of transfer and a secured credit transaction and in structuring any securitisation, it is essential that this line is clearly drawn as to where the assignment amounts to a true sale and where a security interest is intended as the incidence of both transactions are clearly distinct.

Thus, the following features are essential in avoiding the transaction being re-characterised as a loan with security:

i. The sale agreement should express, as clearly as possible, that the transfer is a sale.

ii. The sale agreement should reflect the parties' separate identities and legal roles. The sale agreement should be on arms-length terms and include an appropriate purchase price.

iii. The seller should have no right of redemption whether legal or equitable and howsoever described or contained.

iv. The sale agreement should clearly document the passing of ownership risk to the SPV.

v. The sale agreement should not provide post-transfer rights to the originator in respect of funds generated from transferred receivables.

Reversion of Transfer and Insolvency Remoteness of the SPV

Two key legal issues that must also be considered particularly in the light of the insolvency of the originator is the possibility of reversion of the transfer and the issue of the remoteness of the SPV to the originator so that in sequestrating the assets of the originator, the assets of the SPV are not attached.

Regarding the reversion of the transfer, it is essential to avoid or minimise the risk that the transaction (transfer of receivables) is unwound at some future date by the originator, or a liquidator or administrator of the originator. Generally, the possible grounds on which an administrator or liquidator may be entitled to claw back assets from the SPV are:

i. A transaction at an undervalue

ii. A preference

iii. An extortionate credit transaction

iv. A fraudulent transfer

It thus behoves on the transaction lawyers to ensure that the transfer is not undervalued, there is no fraudulent preference of creditors, the credit transaction is not perceived as extortion and that the transaction is devoid of fraud.

On the issue of insolvency remoteness of the SPV, it is expedient that as far as legally possible, the SPV is isolated from compulsory or voluntary insolvency proceedings of the originator. This is because the jurisdiction. The steps that are taken to achieve "insolvency remoteness" and ensure that the SPV is treated separately from the originator are:

i. The SPV should be a distinct legal entity capable of holding assets and carrying on business and operating on a solvent basis, separately from the originator.

ii. Appointing directors (or a director,) independent of the originator whose vote is required to pass a board resolution relating to the SPV's insolvency. Such Directors of the SPV should be independent and be in a position to approve activities of the SPV, not simply rubber stamp the originator's decisions.

iii. Placing restrictions on the SPV that prevent it from incurring any liabilities outside those contemplated by the securitisation. The SPV should clearly hold itself out as doing business separately from the originator and its corporate authorisations through board meetings, or other requisite authorisations, should be properly documented and recorded.

iv. Including clauses in agreements between the SPV and third parties that prohibit the third parties from commencing insolvency procedures against the SPV.

v. Including limited recourse wording in all significant transaction documents that restricts a counterparty taking enforcement action in respect of the SPV's assets to those assets which the SPV actually holds and in respect of which the counterparty has security.

(16) **IMPORTANT CASE LAW ON SECURITISATION AND RECONSTRUCTION OF FINANCIAL ASSETS AND ENFORCEMENT OF SECURITY INTEREST ACT, 2002**

The important case law on Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (Act No.54 of 2002) (hereinafter for brevity's sake called "SARFAESI Act") is being discussed to serve as a ready reference in case of need. An attempt is being made to discuss the case law as it has evolved since its enactment. While every care is taken to cover all important decisions of the various High Courts and the Hon'ble Supreme Court, the full text of the Judgments may be referred to for any specific contextual reference.

1. Constitutional Validity- the Constitutional validity of the Act was questioned in ***Mardia Chemicals Limited Vs Union of India* [1].** The Hon'ble Supreme Court while upholding the constitutional validity of the SARFAESI Act declared as ultra vires sub-section (2) of section 17 and also made the following observations:

· It is incumbent upon the secured creditor to serve 60 days notice before proceeding to take any of the measures as provided under sub-section (4) of section 13 of the act. After service of notice, if the borrower raises any objection or places facts for consideration of the secured creditor, such reply to the notice must be considered with due application of mind and the reasons for not accepting the objections, howsoever brief they may be, must be communicated to the borrower. In connection with this conclusion, we have already held a discussion in the earlier part of the judgment. The reasons so communicated shall only be for the purposes of the information/knowledge of the borrower without giving rise to any right to approach the Debt Recovery Tribunal under section 17 of the Act at that stage.

· On measures having been taken under sub-section (4) of section 13 and before the date of sale/auction of the property it would be open for the borrower to file an appeal (petition) under section 17 of the Act before the Debt Recovery Tribunal.

· The Tribunal in exercise of its ancillary powers shall have jurisdiction to pass any stay/interim order subject to the condition as it may deem fit and proper to impose.

· The requirement of deposit of 75% of amount claimed before entertaining an appeal (petition) under section 17 of the Act is an oppressive, onerous and arbitrary condition against all the canons of reasonableness. Such a condition is invalid and was therefore struck down.

2. Off-shoot of the Decision in Mardia Chemicals – ***The Act was amended w.e.f. 11.11.2004*** **[2]** in the light of the observations of the Hon'ble Supreme Court in Mardia Chemicals Case and the following major amendments to the Act were carried out -

Section 3-A was inserted providing for an opportunity to the borrower to make a representation or raise objections against the demand notice issued under sub-section (2) of

Section 13 and disposal of such representation within one week from the date of its receipt. A proviso was inserted that the reasons communicated to the borrower in response to the representation shall not confer any right upon him to prefer an application to the Debt Recovery Tribunal.

· Sub-section (2) of Section 17 which provided that the appeal filed by the Borrower against the measures taken by the secured creditor under sub-section (4) of section 13 shall not be entertained unless the borrower deposited with the Debt Recovery Tribunal 75% of the amount claimed under demand notice with a proviso that the Debts Recovery Tribunal may waive or reduce the amount for reasons to be recorded in writing have been substituted with the provision that the Debt Recovery Tribunal shall consider whether any of the measures referred in sub-section (4) of section 13 taken by the secured creditor are in accordance with the provisions of the Act and rules made there under.

· The provision of Appeal to the Appellate Tribunal under section 18 were also modified accordingly, providing that the appellate tribunal shall not entertain any appeal against the Order made by the Debts Recovery Tribunal under section 17, unless 50% of the amount of debt due is deposited with the Appellate Tribunal with a proviso that the Appellate Tribunal is vested with the discretion to reduce the amount to not less than 25% of the debt.

· The Recovery of Debts Due to Banks and Financial Institutions Act was also amended to include a proviso to section 19 (1) to the effect that the bank or financial institution may, with the permission of the Debts Recovery Tribunal, withdrawn the application whether made before or after the Enforcement of Security Interest and Recovery of Debt Laws (Amendment) Act, 2004 for the purposes of taking action under the SARFAESI Act. The interpretation of this proviso came for consideration in a subsequent case decided by the Hon'ble Supreme Court, in the matter of ***Transcore Vs Union of India.***

3. <u>Simultaneous Proceedings under DRT and SARFAESI</u> -

***Transcore Vs Union of India*[3]** – The following important issues came to be considered in Transcore's Case -

(i) Whether the banks or financial institutions having elected to seek their remedy in terms of DRT Act, 1993 can still invoke the SARFAESI Act, 2002 for realizing the secured assets without withdrawing or abandoning the O. A. filed before the DRT under the DRT Act.

(ii) Whether recourse to take possession of the secured assets of the borrower in terms of Section 13 (4) of the SARFAESI Act comprehends the power to take actual possession of the immovable property.

Held, that withdrawal of application pending before Debts Recovery Tribunal is not a pre-condition for taking action under SARFAESI Act. It is for the bank/FI to exercise its discretion as to cases in which it may apply for leave and in cases where they may not apply for leave to withdraw. We do not wish to spell out those circumstances because the said first proviso to Section 19 (1) is an enabling provision, which provision may deal with myriad circumstances which we do not wish to spell out herein.

The authorized officer is like a court receiver under Order XL Rule 1 Civil Procedure Code. He can take either symbolic possession and in appropriate cases he can take actual possession also. There is no dichotomy between symbolic and physical possession.

See Also ***Ace Media Advertisers Pvt. Ltd. Vs Bank of Baroda [4](Allahabad HC)***

4. Approaching High Court under Art 226 when alternative remedy is available & Proceeding against Guarantor's property without exhausting action against Principal Borrower-

In ***United Bank of India Vs Satyawathi Tondon and others [5]*** the Hon'ble Supreme Court observed that it is a matter of serious concern that despite repeated pronouncement of this Court, the High Courts continue to ignore the availability of statutory remedies under the DRT Act and SARFAESI Act and exercise jurisdiction under Article 226 for passing orders which have serious adverse impact on the right of banks and other financial institutions to recover their dues. We hope and trust that in future the High Courts will exercise their discretion in such matters with greater caution, care and circumspection.

Further, the Hon'ble Supreme Court held that issuing notices to guarantor under Section 13 (2) and (4) and filed an application under section 14 of the SARFAESI Act without first initiating action against the borrower for recovery of the outstanding dues is permissible.

The following decisions were also referred for the proposition that the Bank can proceed against the guarantor before exhausting the remedy against the principal borrower. –

Bank of Bihar Ltd. v. Damodar Prasad [6]

State Bank of India v. M/s. Indexport Registered and others [7]

Industrial Investment Bank of India Limited v. Biswanath Jhunjhunwala [8]

5. Whether DRT has jurisdiction to go into post 13 (4) action?

Authorised Officer Indian Overseas Bank Vs Ashok Saw Mill [9]

The intention of the legislature is, therefore, clear that while the Banks and Financial institutions have been vested with stringent powers for recovery of their dues, safeguards have also been provided for rectifying any error or wrongful use of such powers by vesting the DRT with authority after conducting an adjudication into the matter to declare any such action invalid and also to restore possession even though possession may have been made over to the transferee. The consequences of the authority vested in DRT under sub-Section (3) of Section 17 necessarily implies that the DRT is entitled to question the action taken by the secured creditor and the transactions entered into by virtue of Section 13 (4) of the Act. The Legislature by including Sub-Section (3) in section 17 has gone to the extent of vesting the DRT with authority to even set aside a transaction including sale and to restore possession to the borrower in appropriate cases.

Also refer *Anand Jayant More Vs Bank of India [10]*

***6.* <u>Writ Jurisdiction not appropriate remedy when alternative remedy is available-</u>**

Triveni Alloys Limited Vs BIFR [11] When 3/4th thth of the secured creditors have taken a decision to initiate action under SARFAESI Act, it amounts to measure taken to recover their dues as mentioned under Section 13(4) of the SARFAESI Act. The aggrieved party may approach the DRT and not the High Court. Very often something which is not mentioned can be implied by necessary implication.

V.*Sriramulu Vs Karur Vyasya Bank Ltd & ors [12]*

Y.L.K.Prasad son Vs Central Bank of India [13]

Punjab National Bank Vs Imperial Gift House [14] (***Supreme Court)***

Bharat Lal Vs Punjab National Bank Housing Finance Ltd.[15](Allahabad)

Eppanapally Ravi Vs Canara Bank, Rajendranagar Branch, Hyderabad [16] (AP)

Sri Kodandaram Alloys Pvt. Limited rep by its Managing Director Bs. SBI [17]

7. <u>Reply to representation/objections raised by borrower under Section 13 (3-A)</u>

Malhotra Tractors Vs Chief Manager, SBI, Faizabad [18]

The provisions contained in Section 13 (3-A) are mandatory in nature and the Bank as well as the authority have no right to proceed in violation of this provision. It is open to the authorities to proceed further under section 13 (4) only after the representation or objection of the borrower or guarantor is decided by passing a speaking or reasoned order on the basis of material on record.

Kirandevi Bansal Vs Deputy General Manager (Authorised Officer)[19] - The time limit of one week prescribed under sub-section 3 A to Section 13 is only directory. Before any proceeding is initiated under sub section 4 of section 13, it is obligatory on the part of the secured creditor to communicate the reasons for non acceptance of the representation/objections submitted by the borrower. The Legislation has fixed the time limit of one week to see that the proceeding initiated u/s 13 is expedited so that there may be some finality in the action. Held, that period of one week is only directory provision and non compliance of time limit as such will not vitiate the proceedings provided the reason for rejection of the objection is communicated to the borrower before taking action under section 13 (4).

***Also refer Industrial Development Bank of India Ltd. Chennai Vs Kamaldeep Synthetics Ltd [20]* -** Possession notice issued under sec 13 (4) would not be vitiated by the delay in communicating the reasons for rejection of the representation/objections.

Tensile Steels Ltd Vs Punjab and Sindh Bank and ors [21]- Possession ordered to be delivered back as Bank failed to comply with mandatory requirement of the provisions of Sec 13 (3-A).

8. Power of the DRAT to order deposit of 50% of the debt and the challenge to the rate of interest -

***Indian Bank Vs. Blue Jaggers Estates Limited and others [22]* -** The contention of the Appellant that DRAT has no power to insist for deposit of 50% debt without the debt being determined was rejected by the Supreme Court. The Supreme Court further held that contentions of the appellant that the rate of interest is unconscionable, expropriatory and contrary to law, merits no consideration. It was further held that the appellant cannot question the agreed rate of interest when he signed the agreement with open eyes and agreed to abide by the terms and conditions of loan documents. Doctrine of unconscionable contract cannot be invoked for frustrating the action initiated by the bank for recovery of its dues.

9. Pendency of Civil Suit or execution petition or obtaining a decree is no bar to proceed under SARFAESI Act - It was held in the following cases that a pending civil suit or execution petition is no bar to proceed under SARFAESI Act

Mrs. Sunanda Kumari and another Vs Standard Chartered Bank [23](Karnataka)

Kerala. Abdul Azeez Vs Punjab National Bank [24] (Kerala)

10. Claim under SARFAESI can be only to the extent of decree/order passed by DRT

Ace Media Advertisers Pvt. Ltd. Vs. Bank of Baroda [25]

It has been held in the above case that the process under Securitisation Act can be confined to the extent of the decree/order passed by Debts Recovery Tribunal.

11. Insolvency Petition Vs SARFAESI-

Indian Overseas Bank, Brodipet Branch, Guntur Vs Popuri Veeraiah[26]

Borrower filing Insolvency Petition and official receiver appointed. The claim of the Bank admitted in the Insolvency Petition. Sec 10 of the Provincial Insolvency Act, 1920 exempts corporations or companies from being proceeded against. Therefore, the question of invoking provisions of Provincial Insolvency Act against the Bank does not arise nor is valid. As the Bank had already initiated the process under SARFAESI Act, the proceedings need not be stopped in view of the Insolvency Petition.

12. Section 14 – Nature of powers that are exercisable by the District Magistrate or Chief Metropolitan Magistrate-

Puran Maharashtra Automobiles Vs Sub Divisional Magistrate [27] -The nature of the powers that are exercised by the DM or CMM are purely executionery in nature and particularly when no element of quasi-judicial functions or application of mind is required while exercising the said powers, it cannot be said that the DM is a persona designate and that he cannot delegate the powers to other officer.

Arjun Urban Co-operative Bank Ltd, Sholapur Vs Chief Judicial Magistrate, Solapur [28] - Sec 14 clearly refers to CMM and CM. Two distinct authorities are provided by the statue. There is no casus omissus here. It is well settled that at the stage of Sec 14, there is no adjudication of any issues. The authorities have to only render assistance to the secured creditor to recover possession.

Union Bank of India Vs State of Maharashtra [29]- Sec 14 is procedural in nature and merely empowers the CMM or DM to assist the secured creditor in taking possession of the secured assets and it does not clothe the DM with the power to adjudicate in respect of any dispute pertaining to secured assets. Also refer***Kotak Mahindra Bank Limited Vs District Magistrate [30]***

Gujarat Industrial Co-op Bank Ltd Vs District Magistrate [31]- Sec 14 is relatable to taking possession of a secured asset. The District Magistrate is not entitled to re-open a concluded issue subsequently.

Please refer to ***Authorised Officer Canara Bank Vs Sulay Traders thro Bipin Kantilal Vakta [32]-*** for the proposition that the DM is to verify the record to the extent that the condition precedent for exercise of the power by the Bank are satisfied.

Sundaram BNP Paribas Home Finance Ltd Vs State of Kerala [33]- The employment of any physical power to dispossess even in terms of a statute or enforceable order could be only had in exercise of the police power of the State. Even a Court does not have the power to dispossess by force through its officer, but has the power to secure it only through the police machinery of the State. That power cannot be conceded to any individual or institution empowered to take possession, except in cases where the power to physically dispossess is also expressly conferred. That such power has not been conferred by Parliament on a secured creditor under the Act. The DM has to exercise the power by himself and cause the relief to be worked out under his control. That cannot be delegated.

Ayishumma Vs Hassan ***[34]-*** It is very much clear that absolutely no power, jurisdiction, competence or expertise is intended or vested with the Magistrate to deal with any claim as to the nature of the property in question or as to the merits or demerits with regard to other aspects involved in connection with loan transaction, but for considering whether the property in question in respect of which assistance is sought is a secured asset or not. For similar proposition refer***Vaishnavi Pulvarising Mills Ltd Vs SBI, Stressed Assets Management Branch, Chennai*** ***[35]***

Issue of Notice to the Borrower by the Metropolitan Magistrate – The question whether the Metropolitan Magistrate while considering an application under section 14, is required to give notice to the borrower was considered in the following cases and it was held that there is no requirement to issue such notice.

A.Aboobacker Vs PNB & others [36]

Mrs. Sunanda Kumari and another Vs Standard Chartered Bank [37]

Vijaya Bank, S.D Road Branch, Secunderabad Vs Shameem Transport, Bangalore[38]

State Bank of India Vs Kathikkal Tea Plantations, Melur [39]

13. Exercise of power by Additional Collector under section 14 -

Irshad Hussain Vs District Magistrate, Moradabad [40]

Where the Additional Collector has similar power as of Collector under Sec 14 A of the UP Land Revenue Act, 1901, the Order passed by the Additional Collector cannot be said to be without jurisdiction.

13. Demand Notice to Guarantor Mandatory - Notice to guarantor under SARFAESI Act is mandatory. Proceedings without such notice will be vitiated.***Mahavir Plantations Pvt Ltd Vs K.K.Steel Enterprises Vs ICICI Bank Ltd.*** **[41]**

14. Demand Notice not giving details of the amount payable –

Madhusudhan Ghosh Vs Bank of Baroda [42] - Sec 13 (2) notice shall give details of the amount payable by the borrower on the secured assets intended to be enforced. As no details of the amount payable has been supplied to the borrower, showing the debit and credit balance resulting therein, there is a serious infirmity in issuing the notice and vitiates the entire procedure adopted for realization.

15. In Bank's claim application before the DRT, stay application filed by the Borrower to stop SARFAESI action initiation by the Bank is not maintainable ***- S.K.Viji & another Vs Indian Overseas Bank & Others*****[43] -** Application for stay of proceedings initiated by the Bank under SARFAESI Act in the claim application filed by the Bank not maintainable. Appeal dismissed. Parties have been given liberty to file appeal/application under Section 17 of SARFAESI Act, if they so choose.

16. <u>Security Interest under Lease/tenancy to third party</u> –

Shikshak Sahakari Bank Ltd & another Vs Indian Oil Corporation Ltd & Another [44]

Property mortgaged to the Bank leased out to a third party. Bank taking symbolic possession of the property. Possession is subject to the lease hold rights of the Lessee. Lessee directed to pay monthly rent to the Bank before physical possession of the property is delivered to the bank. Provisions of Section 65 (a) of the Transfer of Property Act is not inconsistent with Section 13 of SARFAESI Act. Provisions of 65 (a) of T.P. Act is being subject to lis pendens embodied in Sec 52 of Transfer of Property Act.

Khaja Atheequlah Vs Union Bank of India [45] - On exercise of powers under the Act, the Bank assumes to itself the right to put the property to sale. This is, in a way, comparable to the power of a executing court to enforce a decree. Any step taken preceding the sale, can be equated to attachment. The attachment of an immovable property in course of execution of decree does not entail in dispossession of a person, who is otherwise entitled to remain in it. In case there is a tenant in respect of a building, which is sought to be sold, in the course of execution, the tenant cannot be evicted or thrown away on mere account of attachment. Even if sale is successfully conducted, tenancy has to be attorned in favour of the higher bidder on conclusion of sale. Therefore, the steps taken by the Bank to seal the premises and thereby disabling the petitioners from undertaking business, cannot be sustained in law.

Pankaj Kumar Chandulal Antala Vs Central Bank of India [46]

The question of possession or occupation of the premises will have to agitated under Sec 17 (4) r/w Sec 35 of SARFAESI Act. No protection is available as the State Rent Act is created by State statute and the SARFAESI Act being a Central Act is later in time. Even unregistered lease in contravention of sec 65 A of TP Act cannot be pressed into service for any protection by an occupier.

Nitco Roadways Private Limited, Bangalore Vs Punjab National Bank[47] - If the secured asset is in possession of bona fide tenants or lessees, they cannot be thrown out by invoking sec 13 & 14 of the Act. The secured creditor/bank can only take symbolic possession from the bona fide tenants. The secured creditor has to take recourse to appropriate legal proceedings for taking actual possession from the tenants or lessees. Reference made to ***Hutchison Essar South Limited Vs Union Bank of India and another [48]***

17. <u>Rule 9 (4) – Granting extension of time for payment of the balance of sale price-</u>

Kalu Ram Vs State of UP [49]

It is clear that neither Rule 9 (4) nor the terms and conditions of the sale cast any statutory obligation on the authorized officer or the Bank to consider the application of the petitioner for extension of time.

18. <u>Encashment of TDRs offered as collateral security without waiting for 60 days-</u>

Adi Jogesh Radia Vs State of West Bengal [50] - Writ filed contending that within 5 days of issue of notice under Sec 13 (2), Bank issued a letter informing that certain fixed deposits and other collateral securities had been encashed, without waiting for the period of 60 days. Held, that the secured creditor cannot resort to any measures specified in Sec 13 (4) till the expiry of 30 days and hence the action of encashing TDRs is not contrary to the scheme of the Act.

19. <u>Section 35</u>

SBI Vs Heera Laxmi Contractors Pvt. Ltd. [51](Mumbai HC)

Kohinoor Creations Vs Syndicate Bank [52](Delhi HC).

Section 35 of the SARFAESI Act will over ride the provisions Arbitration and Conciliation Act 1996. It cannot be pleaded that the dispute with regard to auction should be resolved through Arbitration and Conciliation Act.

20. <u>EPF dues have priority over dues of Secured Creditor</u>

Bank of India Vs Assistant Provident Commissioner [53]

Dues under EPF will have priority over the dues of the Secured Creditor. There is no specific provision in the SARFAESI Act which enable the Bank to claim statutory charge. It is not the intention of the SARFAESI ACT to disturb the social welfare policy embedded in Sec 11(2) of the E.P.F Act.

21. <u>Income Tax attachment order prior to creation of security interest</u>

UCO Bank Vs Union of India [54] - In the absence of any specific provisions in SARFAESI Act creating any first charge in favour of the Bank, Sec 281 b of the Income Tax Act r/w Rule 16 of the Second Schedule of the IT Act will have over-riding effect. The provisional attachment being prior to the creation of the security interest, the subsequent action of the Bank under SARFAESI, the notice issued by Tax Recovery Officer to UCO Bank demanding the sale proceeds in respect of property is legal.

22. <u>Limitation</u>

A. Venkata Ramana Vs LIC Housing Finance Ltd.[55]

Limitation for enforcement of security Interest under SARFAESI Act is 12 years. No need to withdraw pending civil suit before proceeding under SARFAESI Act.

23. <u>Limitation – Applicability of Sec 5 to application under Sec 17 (1)-</u>

La Kozy Vs ING Vysya Bank Ltd [56]- Though as observed in ***UCO Bank Vs Kanji Manji Kothari and Co. and ors [57]*** section 5 of the Limitation Act is applicable for proceedings u/s 17 (1) of SARFAESI Act, it does not mean that DRT is obliged to entertain the proceedings even after the same has become hopelessly barred by limitation and no sufficient cause for condoning delay is made out.

24. <u>When can the mortgagor redeem the property</u>

Shakeena P.Sahul Hameed Vs Bank of India and others [58]

Mortgagor can redeem the property sold by the Bank in SARFAESI auction before Registration of sale certificate. Until the sale is complete by registration the mortgagor does not lose right of redemption. When question of law is involved writ petition is maintainable even though alternate remedy is available

<u>When sale becomes complete, vesting right in property in favour of auction purchaser-</u>

K.Chidambara Manickam Vs. Shakeena and Others [59]

When once Sale Certificate is issued as per Rule 9 (7) of the Rules, sale is complete and absolute and the same need not be registered under the provisions of the Registration Act.

25. <u>Notice of assignment to ARCIL whether necessary</u>

Sashi Agro Foods (P) Ltd Vs Andhra Bank [60]

SARFAESI proceedings initiated by a Bank can be continued by ARCIL after assignment of debt, no further notice is required. But some payments were made and MOU had been entered with Bank, it would be prudent to issue a notice by mentioning the payments.

<u>Assignment set aside in the matter of</u> ***Arunachalam Murthu Vs State Bank of India[61]*** on the ground that the assignment of the debt of Helios Company by SBI in favour of Kotak Mahindra Bank Ltd was less than the offer of OTS made by the Company.

26. <u>Non payment of balance price bid – Whether sale can be confirmed in favour of second highest bidder-</u>

Ullas Chandra Sahoo Vs Bank Of India, Bhubaneswar [62]

If the highest bidder fails to deposit 25% of the bid amount, the property cannot be sold to the second highest bidder. “sold again forth with” as contemplated in Rule 9(3) of the Security

Interest Rule does not mean that the property shall be sold to the second highest bidder. Entire process of sale by public auction shall have to be conducted again.

27. Partial Payment subsequent to demand notice - Whether can make the asset come out of NPA

Chembeti Brahmaih Chowdhary VsState Bank Of Hyderabad [63]

Any payment made by the borrower subsequent to issuance of invocation of SARFAESI proceedings by the bank, the loan account of the borrower cannot come out of NPA classification.. Also refer to ***Azam Food Products Pvt Ltd Vs DRAT Chennai [64]***

28. When and within what time does the right to approach DRT accrue to the Borrower

UCO Bank Vs Kanji Manji Kothari and Company and others [65]

Borrower can approach the DRT with in 45 days from the date when symbolic possession is taken or from the date when actual possession is taken. Provisions of Section 5 of limitation Act is applicable as there is no express exclusion of Limitation Act.

Also refer –

D.M.Nangia Engineering & Contractors & Others Vs Bank Of Maharashtra [66]DRAT Mumbai.

Union Bank of India VS Chairperson DRAT & Ors [67]

Time limit of 45 days provided in Section 17 of SARFAESI ACT with in which the effected party has to approach the DRT challenging the measures taken under Section 13(4) of the act cannot be extended by taking the aid of Section 5 of the Limitation Act. Akshat Commercial Pvt Ltd Vs Kalpana Chakraborty and Other 2010(2) DRTC 362 Calcutta.

29. Jurisdiction of the Tribunal where Sec 17 (1) proceeding to be initiated –

Elements Coke Pvt. Ltd. Vs UCO Bank [68]- Since action u/s 13 (4) is in the nature of execution proceeding, the Tribunal within whose territorial jurisdiction the secured assets is situate is the only competent Tribunal whose jurisdiction can be invoked.

30. Agricultural Property – Change in nature of use of land

Gajula Exim (P) Ltd Vs Authorised Officer, Andhra Bank [69]

Possession notice issued by the bank was challenged before DRT stating that the property was an agricultural property. DRT dismissed the same stating that there were plant and machinery and building in the land. The borrower approached the High Court. High Court dismissed the writ petition among other things stating that the borrower failed to prove that any agricultural operations are being conducted in any part of the land. It was held that mere paying Land Revenue cannot be treated as agricultural property.

J.Malliga & Others A.O. Union Bank Of India [70]

Cultivation of cardamom comes with in the term agriculture and SARFAESI Proceedings cannot be initiated against the cardamom estate.

Mohd. Basheer Vs Kannur District Co-operative Bank Ltd [71]

Land planted with rubber be treated as an agriculture and SARFAESI Act cannot be invoked. The order passed by the learned single judge who held that rubber plant does not come within the meaning of agriculture was set a side

Also refer ***Kalpesh PC Surana Vs Indian Bank Teynampet Branch [72]***-The factual issues regarding nature of the land cannot be the subject matter of writ jurisdiction.

31. Proceeding against only one property though demand notice issued in respect of two properties –

Wasan Shoes Ltd Vs Chairperson Debts Recovery Appellate Tribunal, Allahabad[73]

Notice u/s 13 (2) issued mentioning two properties located at Agra and Noida. Possession under Sec 13 (4) confined to one property located at Agra. Held, there is no error in the issue of Sec 13 (2) notice and it is open to the secured creditor to proceed against any secured asset and it is not essential that all the secured properties should be put to sale simultaneously. No error in procedure adopted and there is substantial compliance under Rule 8 (2) of the Rules.

32. SARFAESI Vs. SICA

Noble Aqua Pvt Ltd Vs SBI[74] Kerala. Integrated Rubion Exports Ltd Vs Industrial finance Corporation of India Ltd and others [75]

Provisions of SARFAESI Act override Section 22 of SICA.

Kumar Metallurgical Corporation Limited Vs Asset Reconstructions Company (India) Limited [76] Bhisma N. Thakore Vs Dena Bank [77]

Protection under Section 22 SICA is available to the borrower and not the guarantor. Proceedings pending before BIFR shall stand abated on Bank taking steps under SARFAESI Act.

Also refer ***Nouveaw Exports Private Limited Vs Appellate Authority for Industrial & Financial Reconstruction [78]***

33. Bar of Jurisdiction of Civil Court

Yuth Development Co-operative Bank Ltd Kolhapur Vs Balasaheb Dinakrrao Salokhe & Ors [79]

Civil Court has no jurisdiction to entertain any suit filed in respect of action taken under SARFAESI Act.

Also Refer ***Allahabad Bank Vs Bipin Behari Lal Srivastasva & Ors*** [80]

Punjab National Bank Vs Shaikh Jumman Shakih Guljar [81]

Civil Court not to grant injunction restraining the bank from taking measures under SARFAESI Act as the same is barred under Section 34 of the Act

Sunayana Malhotra & Ors Vs ICICI Bank [82]

Civil Court barred from issuing any injunction in respect of the action taken under SARFAESI Act by a bank or Financial Institution

Also refer ***Saraswat Co-operative Bank Limited formerly Maratha Mandir Co-op Bank Limited Vs Madan S.Jha [83], Fakrudheen Haji Vs SBI (Kerala)[84]and Sumati Vs Sengottian (Madras)[85]***

34. <u>Exercise of powers by Labour Court for recovery of dues for prohibiting the secured creditor from exercising the powers-</u>

Union Bank of India Vs General Workers Union[86]- The Labour Court will have no jurisdiction as per provisions of Sec 35 of SARFAESI Act to prohibit the secured creditor from exercising the powers. The power, if any, can be to the extent that in a given case the amount that is realized by sale of secured assets of a company by a secured creditor may be called upon to give the facts of appropriation and seek for payment proportionately for payment to the workmen dues.

35. <u>Issue of second notice not barred</u>

Omeshwar Baldwa Vs Vasavi Co-Operative Urban Bank Ltd [87]

Issue of fresh/second notice not forbidden. SARFAESI Act not provided any limit within which period steps or measures enumerated under Section 13(4) have got to be accomplished. Conduct of petitioner lulled bank into some kind of hibernation- any intervention by the Court would only be putting a premium to such conduct. Writ petition dismissed.

Davji Farms Ltd & Others Vs Dena Bank and another [88]

No bar to issue second notice –first notice is treated as cancelled

Bhuvanendran Vs LIC Housing Finance Limited [89]. – The Act never stipulates that once notice is issued under section 13 (2) it is inevitably to be followed up by measures contemplated u/s 13 (4). There is no bar under the Act to issue a corrected/fresh notice under section 13 (2).

Sujit Kumar Roy Vs Union of India [90]- The notice was issued under Sec 13 (2) quoting the Second Ordinance. The notice questioned on the ground that no valid notice issued as the Act had already come into force. Held, that mere mentioning a wrong provision would not vitiate the action provided it is relatable to a known source.

36. Payment of Commission to Enforcement Agents

Badugu Vijaya Laxmi Vs State Bank Of India [91]

The Hon'ble High Court has held that services of Enforcement Agents and Recovery Agents comes within the purview of profession and the said persons cannot charge exorbitantly for their services. The Court further held that grant of exorbitant amount of commission to the recovery agents and enforcement agents at a minimum rate of 10% is excessive and disproportionate to the nature of the work to be performed by them. The Court has expressed hope and trust that the bank would focus its attention on payment of fees to the agents and take appropriate measures for remedying the situation, if necessary in consultation with the RBI.

37. Miscellaneous

Ashoka Books (P) LTD Vs State of HP (SBI case) [92]

Bank initiated action under SARFAESI Act. Borrower tried to set Criminal Law into motion against officers of the Bank. Police officers have not taken action against Bank Officers. Borrower filed writ petition. The Act of the Bank and it's Officers can be tested in appropriate Court of competent Jurisdiction. By no stretch of Imagination the action of the Bank be termed as being criminal in nature

Santosh Traders Sons Vs Bhusawal Peoples Co-Op Bank [93]

Bank failed to adduce evidence to show that it had served the notice. DRT directed the Bank to return the movables taken over from the Borrower..

BPPV Classic Tea Factory Pvt Ltd Vs Corporation Bank [94]

Sale proceedings initiated by the secured creditor under SARFAESI Act cannot be challenged under Companies Act.

Dayanath Pandey Vs State Of U.P. [95]

60 days notice under section 13(2) to be counted from the date of notice and not from the date of service. Clear 30 days time from the date of publication of notice of sale not given. Entire recovery proceedings quashed. Sale deed executed was also cancelled.

Krishna Chandra Sahooo Vs Bank Of India [96]

Bank failed to give reply to the objections raised by borrower to the notice issued by the bank under section 13(2). Possession notice issued by the bank quashed.

Sravan Dal Mill Pvt Ltd Vs Central Bank Of India [97]

The borrower has a right to question the classification of NPA by the bank in a writ petition. Bank has been directed to answer the objections raised by the borrower.

Swastik Agency & Others Vs State Bank Of India & Ors[98]

Possession notice in vernacular language was published in English News paper. The same is not in accordance with the rule,. would not serve the purpose

Narender Singh Vs Punjab and Sind Bank & another DRAT Delhi [99]

Demand notice issued in the name of dead person. The bank has not taken any action though informed about the death. Auction conducted was set aside with a liberty to start proceedings afresh. Bank directed to deliver the property bank.

Prakash Agarwal Vs Sapna Dikshit & Others [100]

An auction purchaser at a sale held in execution of a mortgage decree buys not only the interest of the mortgagor but also the interest of the mortgagee. If the lease does not bind the mortgagee, it doest not equally bind the auction purchaser. If the mortgagor grants a lease during the pendency of a suit for sale by the mortgagee, the lessee is bound by the result of the litigation. Neither the mortgagor nor the lessee can defeat the right of mortgagee and no lessee can claim any protection unless his tenancy is as per the requirements of section 64-A of T.P. Act. The writ petition filed by a tenant questioning SARFAESI proceedings initiated by the bank was dismissed.

Forum Diamonds & another Vs Bank of Baroda & Others

Borrower challenged the order of DRAT who directed to deposit 50% of the debt due as a precondition to hear appeal filed by him. The borrower contended that unless the debt is determined, the DRAT has no power to direct him to deposit the amount. The High court dismissed the writ petition stating that if the said contention is accepted the very purpose of the SARFEASI Act would be defeated

Dr. Pranjivan Puroshottam Zaveri and another Vs Dena Bank

The appellant claiming himself as bona fide purchaser for valuable consideration without notice challenged the action of the bank and disputed the mortgage created in favour of the bank. The High Court held that appellant cannot raise such disputes before DRT. The appellant may redress their grievance by filing civil suits

Signal Apparels Pvt Ltd Vs Canara Bank

Guidelines issued by RBI in relation to classifying NPA should be followed by the bank before issuing notice under Section 13(2) of SARFAESI Act. The judgment discussed at length the meaning of NPA its ambit scope. Writ petition dismissed.

Manjk Industries Vs Union Bank of India

Correct amount due was not mentioned in 13(2) notice. But **account was correctly classified as NPA**. Appellant has not denied about the availment of loan. Typographical mistake is a technical violation, but not vitiate the action.

THE SECURITISATION AND RECONSTRUCTION OF FINANCIAL ASSESTS AND ENFORCEMENT OF SECURITY INTEREST ACT, 2002

(54 OF 2002)

***A**n Act to regulate securitisation and reconstruction of financial assets and enforcement of security interest and for matters connected therewith or incidental thereto.* Be it enacted by Parliament in the Fifty-third year of Republic of India as follows: --

CHAPTER I

PRELIMINARY

1. Short title, extent and commencement

(1) This Act may be called the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

(2) It extends to the whole of India.

(3) It shall be deemed to have come into force on the 21st day of June, 2002.

2. Definitions

(1) In this Act, unless the context otherwise requires,--

(a) "Appellate Tribunal" means a Debts Recovery Appellate Tribunal established under sub-section (1) of section 8 of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (51 of 1993);

(b) "asset reconstruction" means acquisition by any securitisation company or reconstruction company of any right or interest of any bank or financial institution in any financial assistance for the purpose of realisation of such financial assistance;

(c) bank" means--

(i) a banking company; or

(ii) a corresponding new bank; or

(iii) the State Bank of India; or

(iv) a subsidiary bank; or

(v) such other bank which the Central Government may, by notification, specify for the purposes of this Act;

(d) "banking company" shall have the meaning assigned to it in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);

(e) "Board" means the Securities and Exchange Board of India established under section 3 of the Securities and Exchange Board of India Act, 1992 (15of 1992);

(f) "borrower" means any person who has been granted financial assistance by any bank or financial institution or who has given any guarantee or created any mortgage or pledge as security for the financial assistance granted by any bank or financial institution and includes a person who becomes borrower of a securitisation company or reconstruction company consequent upon acquisition by it of any rights or interest of any bank or financial institution in relation to such financial assistance;

(g) "Central Registry" means the registry set up or cause to bet set up under sub-section (1) of section 20;

(h) "corresponding new bank" shall have the meaning assigned to it in clause (da) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);
(ha) "debt" shall have the meaning assigned to it in clause (g) of section 2 of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993;
(i) "Debts Recovery Tribunal" means the Tribunal established under sub-section (1) of section 3 of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (51 of 1993);
(j) "default" means non-payment of any principal debt or interest thereon or any other amount payable by a borrower to any secured creditor consequent upon which the account of such borrower is classified as non-performing asset in the books of account of the secured creditor ;
(k) "financial assistance" means any loan or advance granted or any debentures or bonds subscribed or any guarantees given or letters of credit established or any other credit facility extended by any bank or financial institution;
(l) "financial asset" means debt or receivables and includes--
(i) a claim to any debt or receivables or part thereof, whether secured or unsecured; or
(ii) any debt or receivables secured by, mortgage of, or charge on, immovable property; or
(iii) a mortgage, charge, hypothecation or pledge of movable property; or
(iv) any right or interest in the security, whether full or part underlying such debt or receivables; or
(v) any beneficial interest in property, whether movable or immovable, or in such debt, receivables, whether such interest is existing, future, accruing, conditional or contingent; or
(vi) any financial assistance;
(m) "financial institution" means--
(i) a public financial institution within the meaning of section 4A of the Companies Act, 1956 (1 of 1956);
(ii) any institution specified by the Central Government under sub-clause
(ii) of clause (h) of section 2 of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (51 of 1993);
(iii) the International Finance Corporation established under the International Finance Corporation (Status, Immunities and Privileges) Act, 1958 (42 of 1958);
(iv) any other institution or non-banking financial company as defined in clause (f) of section 45-I of the Reserve Bank of India Act, 1934 (2 of 1934), which the Central Government may, by notification, specify as financial institution for the purposes of this Act;
(n) "Hypothecation" means a charge in or upon any movable property, existing or future, created by a borrower in favour of a secured creditor without delivery of possession of the movable property to such creditor, as a security for financial assistance and includes floating charge and crystallisation of such charge into fixed charge on movable property;
(o) "non-performing asset" means an asset or account of a borrower, which has been classified by a bank or financial institution as sub-standard, doubtful or loss asset,--
(a) in case such bank or financial institution is administered or regulated by any authority or body established, constituted or appointed by any law for the time being in force, in accordance with the directions or guidelines relating to assets classifications issued by such authority or body;
(b) in any other case, in accordance with the directions or guidelines relating to assets classifications issued by the Reserve Bank;

(p) "notification" means a notification published in the Official Gazette;
(q) "obligor" means a person liable to the originator, whether under a contract or otherwise, to pay a financial asset or to discharge any obligation in respect of a financial asset, whether existing, future, conditional or contingent and includes the borrower;
(r) "originator" means the owner of a financial asset which is acquired by a securitisation company or reconstruction company for the purpose of securitisation or asset reconstruction;
(s) "prescribed" means prescribed by rules made under this Act;
(t) "property" means--
(i) immovable property;
(ii) movable property;
(iii) any debt or any right to receive payment of money, whether secured or unsecured;
(iv) receivables, whether existing or future;
(v) intangible assets, being know-how, patent, copyright, trade mark, licence, franchise or any other business or commercial right of similar nature;

(u) "qualified institutional buyer" means a financial institution, insurance company, bank, state financial corporation, state industrial development corporation, trustee or securitisation company or reconstruction company which has been granted a certificate of registration under sub-section (4) of section 3 or any asset management company making investment on behalf of mutual fund or pension fund or a foreign institutional investor registered under the Securities and Exchange Board of India Act, 1992 (15 of 1992) or regulations made thereunder, or any other body corporate as may be specified by the Board;
(v) "reconstruction company" means a company formed and registered under the Companies Act, 1956 (1 of 1956) for the purpose of asset reconstruction;
(w) "Registrar of Companies" means the Registrar as defined in clause (40) of section 2 of the Companies Act, 1956 (1 of 1956);
(x) "Reserve Bank" means the Reserve Bank of India constituted under section 3 of the Reserve Bank of India Act, 1934 (2 of 1934);
(y) "scheme" means a scheme inviting subscription to security receipts proposed to be issued by a securitisation company or reconstruction company under that scheme;
(z) "securitisation" means acquisition of financial assets by any securitisation company or reconstruction company from any originator, whether by raising of funds by such securitisation company or reconstruction company from qualified institutional buyers by issue of security receipts representing undivided interest in such financial assets or otherwise;
(za) "securitisation company" means any company formed and registered under the Companies Act, 1956 (1 of 1956) for the purpose of securitisation;
(zb) "security agreement" means an agreement, instrument or any other document or arrangement under which security interest is created in favour of the secured creditor including the creation of mortgage by deposit of title deeds with the secured creditor;
(zc) "secured asset" means the property on which security interest is created;
(zd) "secured creditor" means any bank or financial institution or any consortium or group of banks or financial institutions and includes—

(i) debenture trustee appointed by any bank or financial institution; or
(ii) securitisation company or reconstruction company, whether acting as such or managing a trust set up by such securitisation company or reconstruction company for the securitisation or reconstruction, as the case may be; or
(iii) any other trustee holding securities on behalf of a bank or financial institution, in whose favour security interest is created for due repayment by any borrower of any financial assistance;
(ze) "secured debt" means a debt which is secured by any security interest;
(zf) "security interest" means right, title and interest of any kind whatsoever upon property, created in favour of any secured creditor and includes any mortgage, charge, hypothecation, assignment other than those specified in section 31;
(zg) "security receipt" means a receipt or other security, issued by a securitisation company or reconstruction company to any qualified institutional buyer pursuant to a scheme, evidencing the purchase or acquisition by the holder thereof, of an undivided right, title or interest in the financial asset involved in securitisation;
(zh) "sponsor" means any person holding not less than ten per cent of the paid-up equity capital of a securitisation company or reconstruction company;
(zi) "State Bank of India" means the State Bank of India constituted under section 3 of the State Bank of India Act, 1955 (23 of 1955);
(zj) "subsidiary bank" shall have the meaning assigned to it in clause (k) of section 2 of the State Bank of India (Subsidiary Banks) Act, 1959 (38 of 1959).

(2) Words and expressions used and not defined in this Act but defined in the Indian Contract Act, 1872 (9 of 1872) or the Transfer of Property Act, 1882 (4 of 1882) or the Companies Act, 1956 (1 of 1956) or the Securities and Exchange Board of India Act, 1992 (15 of 1992) shall have the same meanings respectively assigned to them in those Acts.

CHAPTER II
REGULATION OF SECURITISATION AND RECONSTRUCTION OF FINANCIAL ASSETS OF BANKS AND FINANCIAL INSTITUTIONS

3. Registration of securitisation companies or reconstruction companies

(1) No securitisation company or reconstruction company shall commence or carry on the business of securitisation or asset reconstruction without--
(a) obtaining a certificate of registration granted under this section; and
(b) having the owned fund of not less than two crore rupees or such other amount not exceeding fifteen per cent of total financial assets acquired or to be acquired by the securitisation company or reconstruction company, as the Reserve Bank may, by notification, specify:
PROVIDED that the Reserve Bank may, by notification, specify different amounts of owned fund for different class or classes of securitisation companies or reconstruction companies:
PROVIDED FURTHER that a securitisation company or reconstruction company, existing on the commencement of this Act, shall make an application for registration to the Reserve Bank before the expiry of six months from such commencement and notwithstanding anything contained in this sub-section may continue to carry on the business of securitisation or asset reconstruction until a certificate of registration is granted to it or, as the case may be, rejection of application for registration is communicated to it.

(2) Every securitisation company or reconstruction company shall make an application for registration to the Reserve Bank in such form and manner as it may specify.

(3) The Reserve Bank may, for the purpose of considering the application for registration of a securitisation company or reconstruction company to commence or carry on the business of securitisation or asset reconstruction, as the case may be, require to be satisfied, by an inspection of records or books of such securitisation company or reconstruction company, or otherwise, that the following conditions are fulfilled, namely:--
(a) that the securitisation company or reconstruction company has not incurred losses in any of the three preceding financial years;
(b) that such securitisation company or reconstruction company has made adequate arrangements for realisation of the financial assets acquired for the purpose of securitisation or asset reconstruction and shall be able to pay periodical returns and redeem on respective due dates on the investments made in the company by the qualified institutional buyers or other persons;
(c) that the directors of securitisation company or reconstruction company have adequate professional experience in matters related to finance, securitisation and reconstruction;
(d) that the board of directors of such securitisation company or reconstruction company does not consist of more than half of its total number of directors who are either nominees of any sponsor or associated in any manner with the sponsor or any of its subsidiaries;
(e) that any of its directors has not been convicted of any offence involving moral turpitude;
(f) that a sponsor, is not a holding company of the securitisation company or reconstruction company, as the case may be, or, does not otherwise hold any controlling interest in such securitisation company or reconstruction company;
(g) that securitisation company or reconstruction company has complied with or is in a position to comply with prudential norms specified by the Reserve Bank.
(h) that securitisation company or reconstruction company has complied with one or more conditions specified in the guidelines issued by the Reserve Bank for the said purpose.

(4) The Reserve Bank may, after being satisfied that the conditions specified in subsection (3) are fulfilled, grant a certificate of registration to the securitisation company or the reconstruction company to commence or carry on business of securitisation or asset reconstruction, subject to such conditions which it may consider, fit to impose.
(5) The Reserve Bank may reject the application made under sub-section (2) if it is satisfied that the conditions specified in sub-section (3) are not fulfilled:
PROVIDED that before rejecting the application, the applicant shall be given a reasonable opportunity of being heard.
(6) Every securitisation company or reconstruction company, shall obtain prior approval of the Reserve Bank for any substantial change in its management or change of location of its registered office or change in its name:
PROVIDED that the decision of the Reserve Bank, whether the change in management of a securitisation company or a reconstruction company is a substantial change in its management or not, shall be final.

Explanation: For the purposes of this section, the expression "substantial change in management" means the change in the management by way of transfer of shares or amalgamation or transfer of the business of the company.

4. Cancellation of certificate of registration

(1) The Reserve Bank may cancel a certificate of registration granted to a securitisation company or a reconstruction company, if such company--

(a) ceases to carry on the business of securitisation or asset reconstruction; or

(b) ceases to receive or hold any investment from a qualified institutional buyer ;or

(c) has failed to comply with any conditions subject to which the certificate of registration has been granted to it; or

(d) at any time fails to fulfil any of the conditions referred to in clauses (a) to (g) of sub-section (3) of section 3; or

(e) fails to--

(i) comply with any direction issued by the Reserve Bank under the provisions of this Act; or

(ii) maintain accounts in accordance with the requirements of any law or any direction or order issued by the Reserve Bank under the provisions of this Act; or

(iii) submit or offer for inspection its books of account or other relevant documents when so demanded by the Reserve Bank; or

(iv) obtain prior approval of the Reserve Bank required under subsection (6) of section 3:

PROVIDED that before cancelling a certificate of registration on the ground that the securitisation company or reconstruction company has failed to comply with the provisions of clause (c) or has failed to fulfil any of the conditions referred to in clause (d) or sub-clause (iv) of clause (e), the Reserve Bank, unless it is of the opinion that the delay in cancelling the certificate of registration granted under subsection (4) of section 3 shall be prejudicial to the public interest or the interests of the investors or the securitisation company or the reconstruction company, shall give an opportunity to such company on such terms as the Reserve Bank may specify for taking necessary steps to comply with such provisions or fulfillment of such conditions.

(2) A securitisation company or reconstruction company aggrieved by the order of cancellation of certificate of registration may prefer an appeal, within a period of thirty days from the date on which such order of cancellation is communicated to it, to the Central Government: PROVIDED that before rejecting an appeal such company shall be given a reasonable opportunity of being heard.

(3) A securitisation company or reconstruction company, which is holding investments of qualified institutional buyers and whose application for grant of certificate of registration has been rejected or certificate of registration has been cancelled shall, notwithstanding such rejection or cancellation, be deemed to be a securitisation company or reconstruction company until it repays the entire investments held by it (together with interest, if any) within such period as the Reserve Bank may direct.

5. Acquisition of rights or interest in financial assets

(1) Notwithstanding anything contained in any agreement or any other law for the time being in force, any securitisation company or reconstruction company may acquire financial assets of any bank or financial institution--

(a) by issuing a debenture or bond or any other security in the nature of the debenture, for consideration agreed upon between such company and the bank or financial institution, incorporating therein such terms and conditions as may be agreed upon between them; or

(b) by entering into an agreement with such bank or financial institution for the transfer of such financial assets to such company on such terms and conditions as may be agreed upon between them.

(2) If the bank or financial institution is a lender in relation to any financial assets acquired under sub-section (1) by the securitisation company or the reconstruction company, such

securitisation company or reconstruction company shall, on such acquisition, be deemed to be the lender and all the rights of such bank or financial institution shall vest in such company in relation to such financial assets.
(3) Unless otherwise expressly provided by this Act, all contracts, deeds, bonds, agreements, powers-of-attorney, grants of legal representation, permissions, approvals,
consents or no-objections under any law or otherwise and other instruments of whatever nature which relate to the said financial asset and which are subsisting or having effect immediately before the acquisition of financial asset under sub-section (1) and to which the concerned bank or financial institution is a party or which are in favour of such bank or financial institution shall, after the acquisition of the financial assets, be of as full force and effect against or in favour of the securitisation company or reconstruction company, as the case may be, and may be enforced or acted upon as fully and effectually as if, in the place of the said bank or financial institution, securitisation company or reconstruction company, as the case may be, had been a party thereto or as if they had been issued in favour of the securitisation company or reconstruction company, as the case may be.
(4) If, on the date of acquisition of financial asset under sub-section (1), any suit, appeal or other proceeding of whatever nature relating to the said financial asset is pending by or against the bank or financial institution, save as provided in the third proviso to subsection (1) of section 15 of the Sick Industrial Companies (Special Provisions) Act, 1985 (1 of 1986) the same shall not abate, or be discontinued or be, in any way, prejudicially affected by reason of the acquisition of financial asset by the securitisation company or reconstruction company, as the case may be, but the suit, appeal or other proceeding may be continued, prosecuted and enforced by or against the securitisation company or reconstruction company, as the case may be.

5A. Transfer of pending applications to any one of Debts Recovery Tribunals in certain cases

(1) If any financial asset, of a borrower acquired by a securitisation company or reconstruction company, comprise of secured debts of more than one bank or financial
institution for recovery of which such banks or financial institutions has filed applications
before two or more Debts Recovery Tribunals, the securitisation company or reconstruction company may file an application to the Appellate Tribunal having jurisdiction over any of such Tribunals in which such applications are pending for transfer of all pending applications to any one of the Debts Recovery Tribunals as it deems fit.
(2) On receipt of such application for transfer of all pending applications under subsection (1), the Appellate Tribunal may, after giving the parties to the application an
opportunity of being heard, pass an order for transfer of the pending applications to any one of the Debts Recovery Tribunals.
(3) Notwithstanding anything contained in the Recovery of Debts Due to Banks and Financial Institutions Act, 1993, any order passed by the Appellate Tribunal under subsection (2) shall be binding on all the Debts Recovery Tribunals referred to in sub-section (1) as if such order had been passed by the Appellate Tribunal having jurisdiction on each such Debts Recovery Tribunal.
(4) Any recovery certificate, issued by the Debts Recovery Tribunal to which all the pending applications are transferred under sub-section (2), shall be executed in accordance with the provisions contained in sub-section (23) of section 19 and other provisions of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 shall, accordingly, apply to such execution.

6. Notice to obligor and discharge of obligation of such obligor

(1) The bank or financial institution may, if it considers appropriate, give a notice of acquisition of financial assets by any securitisation company or reconstruction company, to the concerned obligor and any other concerned person and to the concerned registering authority (including Registrar of Companies) in whose jurisdiction the mortgage, charge, hypothecation, assignment or other interest created on the financial assets have been registered.
(2) Where a notice of acquisition of financial asset under sub-section (1) is given by a bank or financial institution, the obligor, on receipt of such notice, shall make payment to the concerned securitisation company or reconstruction company, as the case may be, and payment made to such company in discharge of any of the obligations in relation to the financial asset specified in the notice shall be a full discharge to the obligor making the payment from all liability in respect of such payment.
(3) Where no notice of acquisition of financial asset under sub-section (1) is given by any bank or financial institution, any money or other properties subsequently received by the bank or financial institution, shall constitute monies or properties held in trust for the benefit of and on behalf of the securitisation company or reconstruction company, as the case may be, and such bank or financial institution shall hold such payment or property which shall forthwith be made over or delivered to such securitisation company or reconstruction company, as the case may be, or its agent duly authorised in this behalf.

7. Issue of security by raising of receipts or funds by securitisation company or reconstruction company
(1) Without prejudice to the provisions contained in the Companies Act, 1956 (1 of 1956), Securities Contracts (Regulation) Act, 1956 (42 of 1956), and the Securities and Exchange Board of India Act, 1992 (15 of 1992), any securitisation company or reconstruction company, may, after acquisition of any financial asset under sub-section (1) of section 5, offer security receipts to qualified institutional buyers (other than by offer to public) for subscription in accordance with the provisions of those Acts.
(2) A securitisation company or reconstruction company may raise funds from the qualified institutional buyers by formulating schemes for acquiring financial assets and shall keep and maintain separate and distinct accounts in respect of each such scheme for every financial asset acquired out of investments made by a qualified institutional buyer and ensure that realisations of such financial asset is held and applied towards redemption of investments and payment of returns assured on such investments under the relevant scheme.

(2A)(a)The scheme for the purpose of offering security receipts under sub-section (1) or raising funds under sub-section (2), may be in the nature of a trust to be managed by the securitisation company or reconstruction company, and the securitisation company or reconstruction company shall hold the assets so acquired or the funds so raised for acquiring the assets, in trust for the benefit of the qualified institutional buyers holding the security receipts or from whom the funds are raised.
(b) The provisions of the Indian Trust Act, 1882 (2 of 1882) shall, except insofar as they are inconsistent with the provisions of this Act, apply with respect to the trust referred to in clause (a) above.
(3) In the event of non-realisation under sub-section (2) of financial assets, the qualified institutional buyers of a securitisation company or reconstruction company, holding security receipts of not less than seventy-five per cent of the total value of the security receipts issued under a scheme by such company, shall be entitled to call a meeting of all the qualified institutional buyers and every resolution passed in such meeting shall be binding on the company.

(4) The qualified institutional buyers shall, at a meeting called under sub-section (3), follow the same procedure, as nearly as possible as is followed at meetings of the board of directors of the securitisation company or reconstruction company, as the case may be
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8. Exemption from registration of security receipt

Notwithstanding anything contained in sub-section (1) of section 17 of the Registration Act, 1908 (16 of 1908),--

(a) any security receipt issued by the securitisation company or reconstruction company, as the case may be, under sub-section (1) of section 7, and not creating, declaring, assigning, limiting or extinguishing any right, title or interest, to or in immovable property except insofar as it entitles the holder of the security receipt to an undivided interest afforded by a registered instrument; or

(b) any transfer of security receipts, shall not require compulsory registration.

9. Measures for assets reconstruction

Without prejudice to the provisions contained in any other law for the time being in force, a securitisation company or reconstruction company may, for the purposes of asset reconstruction, having regard to the guidelines framed by the Reserve Bank in this behalf, provide for any one or more of the following measures, namely:--

(a) the proper management of the business of the borrower, by change in, or take over of, the management of the business of the borrower;

(b) the sale or lease of a part or whole of the business of the borrower; (c) rescheduling of payment of debts payable by the borrower;

(d) enforcement of security interest in accordance with the provisions of this Act; (e) settlement of dues payable by the borrower;

(f) taking possession of secured assets in accordance with the provisions of this Act.

10. Other functions of Securitisation Company or Reconstruction Company

(1) Any securitisation company or reconstruction company registered under section 3 may--

(a) act as an agent for any bank or financial institution for the purpose of recovering their dues from the borrower on payment of such fee or charges as may be mutually agreed upon between the parties;

(b) act as a manager referred to in clause (c) of sub-section (4) of section 13 on such fee as may be mutually agreed upon between the parties;

(c) act as receiver if appointed by any court or tribunal:

PROVIDED that no securitisation company or reconstruction company shall act as a manager if acting as such gives rise to any pecuniary liability.

(2) Save as otherwise provided in sub-section (1), no securitisation company or reconstruction company which has been granted a certificate of registration under sub-section (4) of section 3, shall commence or carry on, without prior approval of the Reserve Bank, any business other than that of securitisation or asset reconstruction:

PROVIDED that a securitisation company or reconstruction company which is carrying on, on or before the commencement of this Act, any business other than the business of securitisation or asset reconstruction or business referred to in sub-section (1), shall cease to carry on any such business within one year from the date of commencement of this Act.

Explanation : For the purposes of this section, "securitisation company" or "reconstruction company" does not include its subsidiary.

11. Resolution of disputes

Where any dispute relating to securitisation or reconstruction or non-payment of any amount due including interest arises amongst any of the parties, namely, the bank or financial institution or securitisation company or reconstruction company or qualified institutional buyer, such dispute shall be settled by conciliation or arbitration as provided in the Arbitration and Conciliation Act, 1996 (26 of 1996), as if the parties to the dispute have consented in writing for determination of such dispute by conciliation or arbitration and the provisions of that Act shall apply accordingly.

12. Power of Reserve Bank to determine policy and issue directions

(1) If the Reserve Bank is satisfied that in the public interest or to regulate financial system of the country to its advantage or to prevent the affairs of any securitisation company or reconstruction company from being conducted in a manner detrimental to the interest of investors or in any manner prejudicial to the interest of such securitisation company or reconstruction company, it is necessary or expedient so to do, it may determine the policy and give directions to all or any securitisation company or reconstruction company in matters relating to income recognition, accounting standards, making provisions for bad and doubtful debts, capital adequacy based on risk weights for assets and also relating to deployment of funds by the securitisation company or reconstruction company, as the case may be, and such company shall be bound to follow the policy so determined and the directions so issued.

(2) Without prejudice to the generality of the power vested under sub-section (1), the Reserve Bank may give directions to any securitisation company or reconstruction company generally or to a class of securitisation companies or reconstruction companies or to any securitisation company or reconstruction company in particular as to--

(a) the type of financial asset of a bank or financial institution which can be acquired and procedure for acquisition of such assets and valuation thereof;

(b) the aggregate value of financial assets which may be acquired by any securitisation company or reconstruction company.

12A. Power of Reserve Bank to call for statements and information

The Reserve Bank may at any time direct a securitisation company or reconstruction company to furnish it within such time as may be specified by the Reserve Bank, with such statements and information relating to the business or affairs of such securitisation company or reconstruction company (including any business or affairs with which such company is concerned) as the Reserve Bank may consider necessary or expedient to obtain for the purposes of this Act.

CHAPTER III

ENFORCEMENT OF SECURITY INTEREST

13. Enforcement of security interest

(1) Notwithstanding anything contained in section 69 or section 69A of the Transfer of Property Act, 1882 (4 of 1882), any security interest created in favour of any secured creditor may be enforced, without the intervention of court or tribunal, by such creditor in accordance with the provisions of this Act.

(2) Where any borrower, who is under a liability to a secured creditor under a security agreement, makes any default in repayment of secured debt or any instalment thereof, and his account in respect of such debt is classified by the secured creditor as non-performing asset,

then, the secured creditor may require the borrower by notice in writing to discharge in full his liabilities to the secured creditor within sixty days from the date of notice failing which the secured creditor shall be entitled to exercise all or any of the rights under subsection (4).

(3) The notice referred to in sub-section (2) shall give details of the amount payable by the borrower and the secured assets intended to be enforced by the secured creditor in the event of non-payment of secured debts by the borrower.

(3A) If, on receipt of the notice under sub-section (2), the borrower makes any representation or raises any objection, the secured creditor shall consider such representation or objection and if the secured creditor comes to the conclusion that such representation or objection is not acceptable or tenable, he shall communicate within one week of receipt of such representation or objection the reasons for non-acceptance of the representation or objection to the borrower:

PROVIDED that the reasons so communicated or the likely action of the secured creditor at the stage of communication of reasons shall not confer any right upon the borrower to prefer an application to the Debts Recovery Tribunal under section 17 or the Court of District Judge under section 17A.

(4) In case the borrower fails to discharge his liability in full within the period specified in sub-section (2), the secured creditor may take recourse to one or more of the following measures to recover his secured debt, namely:--

(a) take possession of the secured assets of the borrower including the right to transfer by way of lease, assignment or sale for realising the secured asset;

(b) take over the management of the business of the borrower including the right to transfer by way of lease, assignment or sale for realising the secured asset:

PROVIDED that the right to transfer by way of lease, assignment or sale shall be exercised only where the substantial part of the business of the borrower is held as security for the debt:

PROVIDED FURTHER that where the management of whole of the business or part of the business is severable, the secured creditor shall take over the management of such business of the borrower which is relatable to the security for the debt.

(c) appoint any person (hereafter referred to as the manager), to manage the secured assets the possession of which has been taken over by the secured creditor;

(d) require at any time by notice in writing, any person who has acquired any of the secured assets from the borrower and from whom any money is due or may become due to the borrower, to pay the secured creditor, so much of the money as is sufficient to pay the secured debt.

(5) Any payment made by any person referred to in clause (d) of sub-section (4) to the secured creditor shall give such person a valid discharge as if he has made payment to the borrower.

(6) Any transfer of secured asset after taking possession thereof or take over of management under sub-section (4), by the secured creditor or by the manager on behalf of the secured creditor shall vest in the transferee all rights in, or in relation to, the secured asset transferred as if the transfer had been made by the owner of such secured asset.

(7) Where any action has been taken against a borrower under the provisions of sub-section (4), all costs, charges and expenses which, in the opinion of the secured creditor, have been properly incurred by him or any expenses incidental thereto, shall be recoverable from the borrower and the money which is received by the secured creditor shall, in the absence of any

contract to the contrary, be held by him in trust, to be applied, firstly, in payment of such costs, charges and expenses and secondly, in discharge of the dues of the secured creditor and the residue of the money so received shall be paid to the person entitled thereto in accordance with his rights and interests.

(8) If the dues of the secured creditor together with all costs, charges and expenses incurred by him are tendered to the secured creditor at any time before the date fixed for sale or transfer, the secured asset shall not be sold or transferred by the secured creditor, and no further step shall be taken by him for transfer or sale of that secured asset.

(9) In the case of financing of a financial asset by more than one secured creditors or joint financing of a financial asset by secured creditors, no secured creditor shall be entitled to exercise any or all of the rights conferred on him under or pursuant to sub-section (4) unless exercise of such right is agreed upon by the secured creditors representing not less than three-fourth in value of the amount outstanding as on a record date and such action shall be binding on all the secured creditors:

PROVIDED that in the case of a company in liquidation, the amount realised from the sale of secured assets shall be distributed in accordance with the provisions of section 529A of the Companies Act, 1956 (1 of 1956):

PROVIDED FURTHER that in the case of a company being wound up on or after the commencement of this Act, the secured creditor of such company, who opts to realise his security instead of relinquishing his security and proving his debt under proviso to sub-section (1) of section 529 of the Companies Act, 1956 (1 of 1956), may retain the sale proceeds of his secured assets after depositing the workmen's dues with the liquidator in accordance with the provisions of section 529A of that Act:

PROVIDED ALSO that the liquidator referred to in the second proviso shall intimate the secured creditors the workmen's dues in accordance with the provisions of section 529A of the Companies Act, 1956 (1 of 1956) and in case such workmen's dues cannot be ascertained, the liquidator shall intimate the estimated amount of workmen's dues under that section to the secured creditor and in such case the secured creditor may retain the sale proceeds of the secured assets after depositing the amount of such estimated dues
with the liquidator:

PROVIDED Also that in case the secured creditor deposits the estimated amount of workmen's dues, such creditor shall be liable to pay the balance of the workmen's dues or entitled to receive the excess amount, if any, deposited by the secured creditor with the liquidator:

PROVIDED ALSO that the secured creditor shall furnish an undertaking to the liquidator to pay the balance of the workmen's dues, if any.

Explanation : For the purposes of this sub-section,--

(a) "record date" means the date agreed upon by the secured creditors representing not less than three-fourth in value of the amount outstanding on such date;

(b) "amount outstanding" shall include principal, interest and any other dues payable by the borrower to the secured creditor in respect of secured asset as per the books of account of the secured creditor.

(10) Where dues of the secured creditor are not fully satisfied with the sale proceeds of the secured assets, the secured creditor may file an application in the form and manner as may be

prescribed to the Debts Recovery Tribunal having jurisdiction or a competent court, as the case may be, for recovery of the balance amount from the borrower.
(11) Without prejudice to the rights conferred on the secured creditor under or by this section, the secured creditor shall be entitled to proceed against the guarantors or sell the pledged assets without first taking any of the measures specified in clauses (a) to (d) of sub-section (4) in relation to the secured assets under this Act.
(12) The rights of a secured creditor under this Act may be exercised by one or more of his officers authorised in this behalf in such manner as may be prescribed.
(13) No borrower shall, after receipt of notice referred to in sub-section (2), transfer by way of sale, lease or otherwise (other than in the ordinary course of his business) any of his secured assets referred to in the notice, without prior written consent of the secured creditor.
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14. Chief Metropolitan Magistrate or District Magistrate to assist secured creditor in taking possession of secured asset

(1) Where the possession of any secured assets is required to be taken by the secured creditor or if any of the secured asset is required to be sold or transferred by the secured creditor under the provisions of this Act, the secured creditor may, for the purpose of taking possession or control of any such secured asset, request, in writing, the Chief Metropolitan Magistrate or the District Magistrate within whose jurisdiction any
such secured asset or other documents relating thereto may be situated or found, to take possession thereof, and the Chief Metropolitan Magistrate or, as the case may be, the District Magistrate shall, on such request being made to him--
(a) take possession of such asset and documents relating thereto; and
(b) forward such assets and documents to the secured creditor.
(2) For the purpose of securing compliance with the provisions of sub-section (1), the Chief Metropolitan Magistrate or the District Magistrate may take or cause to be taken such steps and use, or cause to be used, such force, as may, in his opinion, be necessary.
(3) No act of the Chief Metropolitan Magistrate or the District Magistrate done in pursuance of this section shall be called in question in any court or before any authority.

15. Manner and effect of take over of management

(1) When the management of business of a borrower is taken over by a securitisation company or reconstruction company under clause (a) of section 9 or, as the case may be, by a secured creditor under clause (b) of sub-section (4) of section 13, the secured creditor may, by publishing a notice in a newspaper published in English language and in a newspaper published in an Indian language in circulation in the place where the principal office of the borrower is situated, appoint as many persons as it thinks fit--
(a) in a case in which the borrower is a company as defined in the Companies Act, 1956 (1 of 1956), to be the directors of that borrower in accordance with the provisions of that Act; or
(b) in any other case, to be the administrator of the business of the borrower.

(2) On publication of a notice under sub-section (1),--
(a) in any case where the borrower is a company as defined in the Companies Act, 1956 (1 of 1956), all persons holding office as directors of the company and in any other case, all persons holding any office having power of superintendence, direction and control of the business of the borrower immediately before the publication of the notice under sub-section (1), shall be deemed to have vacated their offices as such;

(b) any contract of management between the borrower and any director or manager thereof holding office as such immediately before publication of the notice under sub-section (1), shall be deemed to be terminated;

(c) the directors or the administrators appointed under this section shall take such steps as may be necessary to take into their custody or under their control all the property, effects and actionable claims to which the business of the borrower is, or appears to be, entitled and all the property and effects of the business of the borrower shall be deemed to be in the custody of the directors or administrators, as the case may be, as from the date of the publication of the notice;

(d) the directors appointed under this section shall, for all purposes, be the directors of the company of the borrower and such directors or, as the case may be, the administrators appointed under this section, shall alone be entitled to exercise all the powers of the directors or, as the case may be, of the persons exercising powers of superintendence, direction and control, of the business of the borrower whether such powers are derived from the memorandum or articles of association of the company of the borrower or from any other source whatsoever.

(3) Where the management of the business of a borrower, being a company as defined in the Companies Act, 1956 (1 of 1956), is taken over by the secured creditor, then, notwithstanding anything contained in the said Act or in the memorandum or articles of association of such borrower,--

(a) it shall not be lawful for the shareholders of such company or any other person to nominate or appoint any person to be a director of the company;

(b) no resolution passed at any meeting of the shareholders of such company shall be given effect to unless approved by the secured creditor;

(c) no proceeding for the winding up of such company or for the appointment of a receiver in respect thereof shall lie in any court, except with the consent of the secured creditor.

(4) Where the management of the business of a borrower had been taken over by the secured creditor, the secured creditor shall, on realisation of his debt in full, restore the management of the business of the borrower to him.

16. No compensation to directors for loss of office

(1) Notwithstanding anything to the contrary contained in any contract or in any other law for the time being in force, no managing director or any other director or a manager or any person in charge of management of the business of the borrower shall be entitled to any compensation for the loss of office or for the premature termination under this Act of any contract of management entered into by him with the borrower.

(2) Nothing contained in sub-section (1) shall affect the right of any such managing director or any other director or manager or any such person in charge of management to recover from the business of the borrower, moneys recoverable otherwise than by way of such compensation.

17. Right to appeal

(1) Any person (including borrower), aggrieved by any of the measures referred to in sub-section (4) of section 13 taken by the secured creditor or his authorised officer under this Chapter, may make an application alongwith such fee, as may be prescribed to the Debts Recovery Tribunal having jurisdiction in the matter within forty-five days from the date on which such measure had been taken:

PROVIDED that different fees may be prescribed for making the application by the borrower and the person other than the borrower.

Explanation : For the removal of doubts, it is hereby declared that the communication of the reasons to the borrower by the secured creditor for not having accepted his representation or objection or the likely action of the secured creditor at the stage of communication of reasons to the borrower shall not entitle the person (including borrower) to make an application to the Debts Recovery Tribunal under this sub-section.

(2) The Debts Recovery Tribunal shall consider whether any of the measures referred to in sub-section (4) of section 13 taken by the secured creditor for enforcement of security are in accordance with the provisions of this Act and the rules made thereunder.

(3) If, the Debts Recovery Tribunal, after examining the facts and circumstances of the case and evidence produced by the parties, comes to the conclusion that any of the measures referred to in sub-section(4) of section 13, taken by the secured creditor are not in accordance with the provisions of this Act and the rules made thereunder, and require restoration of the management of the business to the borrower or restoration of possession of the secured assets to the borrower, it may by order, declare the recourse to any one or more measures referred to in sub-section (4) of section 13 taken by the secured creditors as invalid and restore the possession of the secured assets to the borrower or restore the management of the business to the borrower, as the case may be, and pass such order as it may consider appropriate and necessary in relation toany of the recourse taken by the secured creditor under sub-section (4) of section 13.

(4) If, the Debts Recovery Tribunal declares the recourse taken by a secured creditor under sub-section (4) of section 13, is in accordance with the provisions of this Act and the rules made thereunder, then, notwithstanding anything contained in any other law for the time being in force, the secured creditor shall be entitled to take recourse to one or more of the measures specified under sub-section (4) of section 13 to recover his secured debt.

(5) Any application made under sub-section (1) shall be dealt with by the Debts Recovery Tribunal as expeditiously as possible and disposed of within sixty days from the date of such application:

PROVIDED that the Debts Recovery Tribunal may, from time to time, extend the said period for reasons to be recorded in writing, so, however, that the total period of pendency of the application with the

Debts Recovery Tribunal, shall not exceed four months from the date of making of such application made under sub-section (1).

(6) If the application is not disposed of by the Debts Recovery Tribunal within the period of four months as specified in sub-section (5), any part to the application may make an application, in such form as may be prescribed, to the Appellate Tribunal for directing the Debts Recovery Tribunal for expeditious disposal of the application pending before the Debts Recovery Tribunal and the Appellate Tribunal may, on such application, make an order for expeditious disposal of the pending application by the Debts Recovery Tribunal.

(7) Save as otherwise provided in this Act, the Debts Recovery Tribunal shall, as far as may be, dispose of the application in accordance with the provisions of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 and the rules made thereunder.

17A. Making of application to Court of District Judge in certain cases

In the case of a borrower residing in the State of Jammu and Kashmir, the application under section 17 shall be made to the Court of District Judge in that State having jurisdiction over the borrower which shall pass an order on such application.

Explanation : For the removal of doubts, it is hereby declared that the communication of the reasons to the borrower by the secured creditor for not having accepted his representation or objection or the likely action of the secured creditor at the stage of communication of reasons shall not entitle the person (including borrower) to make an application to the Court of District Judge under this section.

18. Appeal to Appellate Tribunal

(1) Any person aggrieved, by any order made by the Debts Recovery Tribunal under section 17, may prefer an appeal alongwith such fee, as may be prescribed to the Appellate Tribunal within thirty days from the date of receipt of the order of Debts Recovery Tribunal:
PROVIDED that different fees may be prescribed for filing an appeal by the borrower or by the person other than the borrower:

PROVIDED FURTHER that no appeal shall be entertained unless the borrower has deposited with the Appellate Tribunal fifty per cent. of the amount of debt due from him, as claimed by the secured creditors or determined by the Debts Recovery Tribunal, whichever is less:

PROVIDED ALSO that the Appellate Tribunal may, for the reasons to be recorded in writing, reduce the amount to not less than twenty-five per cent. of debt referred to in the second proviso.
(2) Save as otherwise provided in this Act, the Appellate Tribunal shall, as far as may be, dispose of the appeal in accordance with the provisions of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (51 of 1993) and rules made thereunder.

18A. Validation of fees levied

Any fee levied and collected for preferring, before the commencement of the Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Act, 2004, an appeal to the Debts Recovery Tribunal or the Appellate Tribunal under this Act, shall be deemed always to have been levied and collected in accordance with law as if amendments made to sections 17 and 18 of this Act by sections 11 and 12 of the said Act were in force at all material times.

18B. Appeal to High Court in certain cases

Any borrower residing in the State of Jammu and Kashmir and aggrieved by any order made by the Court of District Judge under section 17A may prefer an appeal, to the High Court having jurisdiction over such Court, within thirty days from the date of receipt of the order of the Court of District Judge:

PROVIDED that no appeal shall be preferred unless the borrower has diposited, with the Jammu and Kashmir High Court, fifty per cent of the amount of the debt due from him as claimed by the secured creditor or determined by the Court of District Judge, whichever is less:

PROVIDED FURTHER that the High Court may, for the reasons to be recorded in writing, reduce the amount to not less than twenty-five per cent. of the debt referred to in the first proviso.

19. Right of borrower to receive compensation and costs in certain cases

If the Debts Recovery Tribunal or the Court of District Judge, on an application made under section 17 or section 17A or the Appellate Tribunal or the High Court on an appeal preferred under section 18 or section 18A, holds that the possession of secured assets by the secured creditor is not in accordance with the provisions of this Act and rules made thereunder and directs the secured creditors to return such secured assets to the concerned borrowers, such borrower shall be entitled to the payment of such compensation and costs as may be determined by such Tribunal or Court of District Judge or Appellate Tribunal or the High Court referred to in section 18B.

CHAPTER IV

CENTRAL REGISTRY

20. Central Registry

(1) The Central Government may, by notification, set-up or cause to be set-up from such date as it may specify in such notification, a registry to be known as the Central Registry with its own seal for the purposes of registration of transaction of securitisation and reconstruction of financial assets and creation of security interest under this Act.

(1) The head office of the Central Registry shall be at such place as the Central Government may specify and for the purpose of facilitating registration of transactions referred to in sub-section (1), there may be established at such other places as the Central Government may think fit, branch offices of the Central Registry.

(3) The Central Government may, by notification, define the territorial limits within which an office of the Central Registry may exercise its functions.

(4) The provisions of this Act pertaining to the Central Registry shall be in addition to and not in derogation of any of the provisions contained in the Registration Act, 1908 (16 of 1908), the Companies Act, 1956 (1 of 1956), the Merchant Shipping Act, 1958 (44 of 1958), the Patents Act, 1970 (39 of 1970), the Motor Vehicles Act, 1988 (59 of 1988) and the Designs Act, 2000 (16 of 2000) or any other law requiring registration of charges and shall not affect the priority of charges or validity thereof under those Acts or laws.

21. Central Registrar

(1) The Central Government may, by notification, appoint a person for the purpose of registration of transactions relating to securitisation, reconstruction of financial assets and security interest created over properties, to be known as the Central Registrar.

(2) The Central Government may appoint such other officers with such designations as it thinks fit for the purpose of discharging, under the superintendence and direction of the Central Registrar, such functions of the Central Registrar under this Act as he may, from time to time, authorise them to discharge.

22. Register of securitisation, reconstruction and security interest transactions

(1) For the purposes of this Act, a record called the Central Register shall be kept at the head office of the Central Registry for entering the particulars of the transactions relating to--

(a) securitisation of financial assets;

(b) reconstruction of financial assets; and

(c) creation of security interest.

(2) Notwithstanding anything contained in sub-section (1), it shall be lawful for the Central Registrar to keep the records wholly or partly in computer, floppies, diskettes or in any other electronic form subject to such safeguards as may be prescribed.

(3) Where such register is maintained wholly or partly in computer, floppies, diskettes or in any other electronic form, under sub-section (2), any reference in this Act to entry in the Central Register shall be construed as a reference to any entry as maintained in computer or in any other electronic form.

(4) The register shall be kept under the control and management of the Central Registrar.

23. Filing of transactions of securitisation, reconstruction and creation of security

interest
The particulars of every transaction of securitisation, asset reconstruction or creation of security interest shall be filed, with the Central Registrar in the manner and on payment of such fee as may be prescribed, within thirty days after the date of such transaction or creation of security, by the securitisation company or reconstruction company or the secured creditor, as the case may be:
PROVIDED that the Central Registrar may allow the filing of the particulars of such transaction or creation of security interest within thirty days next following the expiry of the said period of thirty days on payment of such additional fee not exceeding ten times the amount of such fee.

24. Modification of security interest registered under this Act
Whenever the terms or conditions, or the extent or operation, of any security interest registered under this Chapter, are, or is, modified, it shall be the duty of the securitisation company or the reconstruction company or the secured creditor, as the case may be, to send to the Central Registrar, the particulars of such modification, and the provisions of this Chapter as to registration of a security interest shall apply to such modification of such security interest.

25. Securitisation company or reconstruction company or secured creditor to report satisfaction of security interest
(1) The securitisation company or reconstruction company or the secured creditor, as the case may be, shall give intimation to the Central Registrar of the payment or satisfaction in full, of any security interest relating to the securitisation company or the reconstruction company or the secured creditor and requiring registration under this Chapter, within thirty days from the date of such payment or satisfaction.

(1A) On receipt of intimation under sub-section (1), the Central Registrar shall order that a memorandum of satisfaction shall be entered in the Central Register.
(2) If the concerned borrower gives an intimation to the Central Registrar for not recording the payment or satisfaction referred to in sub-section (1), the Central Registrar shall on receipt of such intimation cause a notice to be sent to the securitisation company or reconstruction company or the secured creditor calling upon it to show cause within a time not exceeding fourteen days specified in such notice, as to why payment or satisfaction should not be recorded as intimated to the Central Registrar.
(3) If no cause is shown, the Central Registrar shall order that a memorandum of satisfaction shall be entered in the Central Register.
(4) If cause is shown, the Central Registrar shall record a note to that effect in the Central Register, and shall inform the borrower that he has done so.

26. Right to inspect particulars of securitisation, reconstruction and security interest transactions
(1) The particulars of securitisation or reconstruction or security interest entered in the Central Register of such transactions kept under section 22 shall be open during the business hours for inspection by any person on payment of such fee as may be prescribed.
(2) The Central Register, referred to in sub-section (1) maintained in electronic form, shall also be open during the business hours for the inspection of any person through electronic media on payment of such fee as may be prescribed.
CHAPTER V
OFFENCES AND PENALTIES
27. Penalties
If a default is made--

(a) in filing under section 23, the particulars of every transaction of any securitisation or asset reconstruction or security interest created by a securitisation company or reconstruction company or secured creditors; or
(b) in sending under section 24, the particulars of the modification referred to in that section; or
(c) in giving intimation under section 25, every company and every officer of the company or the secured creditors and every officer of the secured creditor who is in default shall be punishable with fine which may extend to five thousand rupees for every day during which the default continues.

28. Penalties for non-compliance of direction of Reserve Bank.-

If any securitisation company or reconstruction company fails to comply with any direction issued by the Reserve Bank under section 12, such company and every officer of the company who is in default, shall be punishable with fine which may extend to five lakh rupees and in the case of a continuing offence, with an additional fine which may extend to ten thousand rupees for every day during which the default continues.

29. Offences.-

If any person contravenes or attempts to contravene or abets the contravention of the provisions of this Act or of any rules made thereunder, he shall be punishable with imprisonment for a term which may extend to one year, or with fine, or with both.

30. Cognizance of offence.-

No court inferior to that of a Metropolitan Magistrate or a Judicial Magistrate of the First Class shall try any offence punishable under this Act.

CHAPTER VI

MISCELLANEOUS

31. Provisions of this Act not to apply in certain cases

The provisions of this Act shall not apply to--

(a) a lien on any goods, money or security given by or under the Indian Contract Act, 1872 (9 of 1872; or the Sale of Goods Act, 1930 (3 of 1930) or any other law for the time being in force;
(b) a pledge of movables within the meaning of section 172 of the Indian Contract Act, 1872 (9 of 1872);
(c) creation of any security in any aircraft as defined in clause (1) of section 2 of the Aircraft Act, 1934 (24 of 1934);
(d) creation of security interest in any vessel as defined in clause (55) of section 3 of the Merchant Shipping Act, 1958 (44 of 1958);
(e) any conditional sale, hire-purchase or lease or any other contract in which no security interest has been created;
(f) any rights of unpaid seller under section 47 of the Sale of Goods Act, 1930 (3 of 1930);

(g) any properties not liable to attachment (excluding the properties specifically charged with the debt recoverable under this Act) or sale under the first proviso to sub-section (1) of section 60 of the Code of Civil Procedure, 1908 (5 of 1908);
(h) any security interest for securing repayment of any financial asset not exceeding one lakh rupees;
(i) any security interest created in agricultural land;
(j) any case in which the amount due is less than twenty per cent of the principal amount and interest thereon.

32. Protection of action taken in good faith

No suit, prosecution or other legal proceedings shall lie against any secured creditor or any of his officers or manager exercising any of the rights of the secured creditor or borrower for anything done or omitted to be done in good faith under this Act.

33 Offences by companies

(1) Where an offence under this Act has been committed by a company, every person who at the time the offence was committed was in charge of, and was responsible to, the company, for the conduct of the business of the company, as well as the company, shall be deemed to be guilty of the offence and shall be liable to be proceeded against and punished accordingly:
PROVIDED that nothing contained in this sub-section shall render any such person liable to any punishment provided in this Act, if he proves that the offence was committed without his knowledge or that he had exercised all due dilligence to prevent the commission of such offence.
(2) Notwithstanding anything contained in sub-section (1), where an offence under this Act has been committed by a company and it is proved that the offence has been committed with the consent or connivance of, or is attributable to any neglect on the part of, any director, manager, secretary or other officer of the company, such director, manager, secretary or other officer shall also be deemed to be guilty of the offence and shall be liable to be proceeded against and punished accordingly.
Explanation : For the purposes of this section,--
(a) "company" means any body corporate and includes a firm or other association of individuals; and
(b) "director", in relation to a firm, means a partner in the firm.

34. Civil Court not to have jurisdiction

No civil court shall have jurisdiction to entertain any suit or proceeding in respect of any matter which a Debts Recovery Tribunal or the Appellate Tribunal is empowered by or under this Act to determine and no injunction shall be granted by any court or other authority in respect of any action taken or to be taken in pursuance of any power conferred by or under this Act or under the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (51 of 1993).

35. The provisions of this Act to override other laws

The provisions of this Act shall have effect, notwithstanding anything inconsistent therewith contained in any other law for the time being in force or any instrument having effect by virtue of any such law.

36. Limitation

No secured creditor shall be entitled to take all or any of the measures under sub-section (4) of section 13, unless his claim in respect of financial asset is made within the period of limitation prescribed under the Limitation Act, 1963 (36 of 1963).

37. Application of other laws not barred

The provisions of this Act or the rules made thereunder shall be in addition to, and not in derogation of, the Companies Act, 1956 (1 of 1956), the Securities Contracts (Regulation) Act, 1956 (42 of 1956), the Securities and Exchange Board of India Act, 1992 (15 of 1992), the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (51 of 1993) or any other law for the time being in force.

38. Power of Central Government to make rules

(1) The Central Government may, by notification and in the Electronic Gazette as defined in clause(s) of section 2 of the Information Technology Act, 2000 (21 of 2000), make rules for carrying out the provisions of this Act.

(2) In particular, and without prejudice to the generality of the foregoing power, such rules may provide for all or any of the following matters, namely:--

(a) the form and manner in which an application may be filed under sub-section (10) of section 13;

(b) the manner in which the rights of a secured creditor may be exercised by one or more of his officers under sub-section (12) of section 13;

(ba) the fee for making an application to the Debts Recovery Tribunal under sub-section (1) of section 17; (bb) the form of making an application to the Appellate Tribunal under sub-section (6) of section 17;

(bc) the fee for preferring an appeal to the Appellate Tribunal under sub-section (1) of section 18;

(c) the safeguards subject to which the records may be kept under sub-section (2) of section 22;

(d) the manner in which the particulars of every transaction of securitisation shall be filed under section 23 and fee for filing such transaction;

(e) the fee for inspecting the particulars of transactions kept under section 22 and entered in the Central Register under sub-section (1) of section 26;

(f) the fee for inspecting the Central Register maintained in electronic form under sub-section (2) of section 26;

(g) any other matter which is required to be, or may be, prescribed, in respect of which provision is to be, or may be, made by rules.

(3) Every rule made under this Act shall be laid, as soon as may be after it is made, before each House of Parliament, while it is in session, for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the rule or both Houses agree that the rule should not be made, the rule shall thereafter have effect only in such modified form or be of no effect, as the case may be; so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that rule.

39. Certain provisions of this Act to apply after Central Registry is set up or caused to be set up

The provisions of sub-sections (2), (3) and (4) of section 20 and sections 21, 22, 23, 24, 25, 26 and 27 shall apply after the Central Registry is set up or caused to be set up under sub-section (1) of section 20.

40. Power to remove difficulties

(1) If any difficulty arises in giving effect to the provisions of this Act, the Central Government may, by order published in Official Gazette, make such provisions not inconsistent with the provisions of this Act as may appear to be necessary for removing the difficulty:
PROVIDED that no order shall be made under this section after the expiry of a period two years from the commencement of this Act.
(2) Every order made under this section shall be laid, as soon as may be after it is made, before each House of Parliament.

41. Amendments of certain enactments
The enactments specified in the Schedule shall be amended in the manner specified therein.

42. Repeal and saving
(1) The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (Second) Ordirance, 2002 (Ord. 3 of 2002), is hereby repealed.
(2) Notwithstanding such repeal, any thing done or any action taken under the said Act shall be deemed to have been done or taken under the corresponding provisions of this Act.

Year	*Act No*	*Short title*	*Amendment*
1956	1	The Companies Act 1956	In section 4A in sub-section (1) after clause (vi) insert the following:-- "(vii) the securitisation company or the reconstruction company which has obtained a certificate of registration under sub-section (4) of section 3 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002".
1956	42	The Securities Contracts (Regulation) Act 1956.	In section 2 in clause (h) after sub-clause (ib) insert the following:-- " (ic) security receipt as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002".
1986	1	The Sick Industrial Companies (Special Provisions) Act 1985.	In section 15 in sub-section (1) after the proviso insert the following:-- "PROVIDED FURTHER that no reference shall be made to the Board for Industrial and Financial Reconstruction after the commencement of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 where financial assets have been acquired by any securitisation company or reconstruction company under sub-section (1) of section 5 of that Act:
			PROVIDED ALSO that on or after the commencement of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002

			where a reference is pending before the Board for Industrial and Financial Reconstruction such reference shall abate if the secured creditors representing not less than three-fourth in value of the amount outstanding against financial assistance disbursed to the borrower of such secured creditors have taken any measures to recover their secured debt under sub-section (4) of section 13 of that Act."

(18) THE SECURITY INTEREST ENFORCEMENT RULES, 2002

In exercise of the powers conferred by sub-section (1) and clause (b) of subsection (2) of section 38 read with sub-sections (4), (10) and (12) of section 13 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (Second) Ordinance, 2002 (Ord. 3 of 2002), the Central Government hereby makes the following rules, namely:--

1. Short title and commencement

(1) These rules may be called the Security Interest (Enforcement) Rules, 2002.

(2) They shall come into force from the date of their publication in the Official Gazette.

2. Definitions

In these rules, unless the context otherwise requires,--

(a) "authorised officer" means an officer not less than a chief manager of a public sector bank or equivalent, as specified by the Board of Directors or Board of Trustees of the secured creditor or any other person or authority exercising powers of superintendence, direction and control of the business or affairs of the secured creditor, as the case may be, to exercise the rights of a secured creditor under the Ordinance;

(b) demand notice means the notice in writing issued by a secured creditor or authorised officer, as the case may be, to any borrower pursuant to sub-section (2) of section 13 of the Ordinance;

(c) "Ordinance" means the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (Second) Ordinance, 2002 (Ord. 3 of 2002);

(d) "approved valuer" means a valuer as approved by the Board of Directors or Board of Trustees of the secured creditor, as the case may be;

(e) words and expressions used and not defined in these Rules but defined in the Ordinance* shall have the meanings respectively assigned to them in the Ordinance.

3. Demand notice

(1) The service of demand notice as referred to in sub-section (2) of section 13 of the Ordinance shall be made by delivering or transmiting at the place where the borrower or his agent, empowered to accept the notice or documents on behalf of the borrower, actually and voluntarily resides or carries on business or personally works for gain, by registered post with acknowledgement due, addressed to the borrower or his agent empowered to accept the service or by Speed Post or by courier or by any other means of transmission of documents like fax message or electronic mail service:

PROVIDED that where authorised officer has reason to believe that the borrower or his agent is avoiding the service of the notice or that for any other reason, the service cannot be made as aforesaid, the service shall be effected by affixing a copy of the demand notice on the outer door or some other conspicuous part of the house or building in which the borrower or his agent ordinarily resides or carries on business or personally works for gain and also by publishing the contents of the demand notice in two leading newspapers, one in vernacular language, having sufficient circulation in that locality.

(2) Where the borrower is a body corporate, the demand notice shall be served on the registered office or any of the branches of such body corporate as specified under sub-rule (1).

(3) Any other notice in writing to be served on the borrower or his agent by authorised officer, shall be served in the same manner as provided in this rule.

(4) Where there are more than one borrower, the demand notice shall be served on each borrower.

4. Procedure after issue of notice

If the amount mentioned in the demand notice is not paid within the time specified therein, the authorised officer shall proceed to realise the amount by adopting any one or more of the measures specified in sub-section (4) of section 13 of the Ordinance for taking possession of movable property, namely:--

(1) Where the possession of the secured assets to be taken by the secured creditor are movable property in possession of the borrower, the authorised officer shall take possession of such movable property in the presence of two witnesses after a Panchnama drawn and signed by the witnesses as nearly as possible in Appendix I to these rules.

(2) After taking possession under sub-rule (1) above, the authorised officer shall make or cause to be made an inventory of the property as nearly as possible in the form given in Appendix-II to these rules and deliver or cause to be delivered, a copy of such inventory to the borrower or to any person entitled to receive on behalf of borrower.

(3) The authorised officer shall keep the property taken possession under sub-rule (1) either in his own custody or in the custody of any person authorised or appointed by him, who shall take as much care of the property in his custody as an owner of ordinary prudence would, under the similar circumstances, take of such property:

PROVIDED that if such property is subject to speedy or natural decay, or the expense of keeping such property in custody is likely to exceed its value, the authorised officer may sell it at once.

(4) The authorised officer shall take steps for preservation and protection of secured assets and insure them, if necessary, till they are sold or otherwise disposed of.

(5) In case any secured asset is:--

(a) a debt not secured by negotiable instrument; or

(b) a share in a body corporate;

(c) other movable property not in the possession of the borrower except the property deposited in or in the custody of any court or any like authority, the authorized officer shall obtain possession or recover the debt by service of notice as under:--

(i) in the case of a debt, prohibiting the borrower from recovering the debt or any interest thereon and the debtor from making payment thereof and directing the debtor to make such payment to the authorised officer; or

(ii) in the case of the shares in a body corporate, directing the borrower to transfer the same to the secured creditor and also the body corporate from not transferring such shares in favour of any person other than the secured creditor. A copy of the notice so sent may be endorsed to the concerned body corporate's Registrar to the issue or share transfer agents, if any;

(iii) in the case of other movable property (except as aforesaid), calling upon the borrowers and the person in possession to hand over the same to the authorized officer and the authorised officer shall take custody of such movable property in the same manner as provided in sub-rules (1) to (3) above;

(iv) movable secured assets other than those covered in this rule shall be taken possession of by the authorised officer by taking possession of the documents evidencing title to such secured assets.

5. Valuation of movable secured assets

After taking possession under sub-rule (1) of rule 4 and in any case before sale, the authorised officer shall obtain the estimated value of the movable secured assets and thereafter, if considered necessary, fix in consultation with the secured creditor, the reserve price of the assets to be sold in realisation of the dues of the secured creditor.

6. Sale of movable secured assets

(1) The authorised officer may sell the movable secured assets taken possession under sub-rule (1) of rule 4 in one or more lots by adopting any of the following methods to secure maximum sale price for the assets, to be so sold--

(a) obtaining quotations from parties dealing in the secured assets or otherwise interested in buying such assets; or

(b) inviting tenders from the public ; or

(c) holding public auction; or

(d) by private treaty.

(2) The authorised officer shall serve to the borrower a notice of thirty days for sale of the movable secured assets, under sub-rule (1):

PROVIDED that if the sale of such secured assets is being effected by either inviting tenders from the public or by holding public auction, the secured creditor shall cause a public notice in two leading newspapers, one in vernacular language, having sufficient circulation in that locality by setting out the terms of sale, which may include,--

(a) details about the borrower and the secured creditor;

(b) description of movable secured assets to be sold with identification marks or numbers, if any, on them;

(c) reserve price, if any, and the time and manner of payment;

(d) time and place of public auction or the time after which sale by any other mode shall be completed;

(e) depositing earnest money as may be stipulated by the secured creditor;

(f) any other thing which the authorised officer considers it material for a purchaser to know in order to judge the nature and value of movable secured assets .

(3) Sale by any methods other than public auction or public tender, shall be on such terms as may be settled between the parties in writing.

7. Issue of certificate of sale

(1) Where movable secured assets is sold, sale price of each lot shall be paid as per the terms of the public notice or on the terms as may be settled between the parties, as the case may be and in the event of default of payment, the movable secured assets shall be liable to be ordered for sale again.

(2) On payment of sale price, the authorised officer shall issue a certificate of sale in the prescribed form as given in Appendix III to these rules specifying the movable secured assets sold, price paid and the name of the purchaser and thereafter the sale shall become absolute. The certificate of sale so issued shall be prima facie evidence of title of the purchaser.

(3) Where the movable secured assets are those referred in sub-clauses (iii) to (v) of clause (1) of sub-section (1) of section 2 of the Ordinance, the provisions contained in these rules and rule 7 dealing with the sale of movable secured assets shall, mutatis mutandis, apply to such assets.

8. Sale of immovable secured assets

(1) Where the secured asset is an immovable property, the authorised officer shall take or cause to be taken possession, by delivering a possession notice prepared as nearly as possible in Appendix-IV to these rules, to the borrower and by affixing the possession notice on the outer door or at such conspicuous place of the property.

(2) The possession notice as referred to in sub-rule (1) shall also be published in two leading newspapers, one in vernacular language having sufficient circulation in that locality, by the authorised officer.
(3) In the event of possession of immovable property is actually taken by the authorised officer, such property shall be kept in his own custody or in the custody of any person authorised or appointed by him, who shall take as much care of the property in his custody as an owner of ordinary prudence would, under the similar circumstances, take of such property.
(4) The authorised officer shall take steps for preservation and protection of secured assets and insure them, if necessary, till they are sold or otherwise disposed of.
(5) Before effecting sale of the immovable property referred to in sub-rule (1) of rule 9, the authorised officer shall obtain valuation of the property from an approved valuer and in consultation with the secured creditor, fix the reserve price of the property and may sell the whole or any part of such immovable secured asset by any of the following methods:--
(a) by obtaining quotations from the persons dealing with similar secured assets or otherwise interested in buying the such assets; or
(b) by inviting tenders from the public;
(c) by holding public auction; or
(d) by private treaty.
(6) The authorised officer shall serve to the borrower a notice of thirty days for sale of the immovable secured assets, under sub-rule (5):

PROVIDED that if the sale of such secured asset is being effected by either inviting tenders from the public or by holding public auction, the secured creditor shall cause a public notice in two leading newspapers; one in vernacular language having sufficient circulation in the locality by setting out the terms of sale, which shall include,--
(a) the description of the immovable property to be sold, including the details of the encumbrances known to the secured creditor;
(b) the secured debt for recovery of which the property is to be sold;
(c) reserve price, below which the property may not be sold;
(d) time and place of public auction or the time after which sale by any other mode shall be completed;
(e) depositing earnest money as may be stipulated by the secured creditor;
(f) any other thing which the authorised officer considers it material for a purchaser to know in order to judge the nature and value of the property.
(7) Every notice of sale shall be affixed on a conspicuous part of the immovable property and may, if the authorised officer deems it fit, put on the web-site of the secured creditor on the Internet.
(8) Sale by any method other than public auction or public tender, shall be on such terms as may be settled between the parties in writing.

9. Time of sale, issue of sale certificate and delivery of possession, etc.
(1) No sale of immovable property under these rules shall take place before the expiry of thirty days from the date on which the public notice of sale is published in newspapers as referred to in the proviso to sub-rule (6) or notice of sale has been served to the borrower.
(2) The sale shall be confirmed in favour of the purchaser who has offered the highest sale price in his bid or tender or quotation or offer to the authorised officer and shall be subject to confirmation by the secured creditor:
PROVIDED that no sale under this rule shall be confirmed, if the amount offered by sale price is less than the reserve price, specified under sub-rule (5) of rule 9:

PROVIDED FURTHER that if the authorised officer fails to obtain a price higher than the reserve price, he may, with the consent of the borrower and the secured creditor effect the sale at such price.

(3) On every sale of immovable property, the purchaser shall immediately pay a deposit of twenty-five per cent of the amount of the sale price, to the authorized officer conducting the sale and in default of such deposit, the property shall forthwith be sold again.

(4) The balance amount of purchase price payable shall be paid by the purchaser to the authorised officer on or before the fifteenth day of confirmation of sale of the immovable property or such extended period as may be agreed upon in writing between the parties.

(5) In default of payment within the period mentioned in sub-rule (4), the deposit shall be forfeited and the property shall be resold and the defaulting purchaser shall forfeit all claims to the property or to any part of the sum for which it may be subsequently sold.

(6) On confirmation of sale by the secured creditor and if the terms of payment have been complied with, the authorised officer exercising the power of sale shall issue a certificate of sale of the immovable property in favour of the purchaser in the form given in Appendix-V to these rules.

(7) Where the immovable property sold is subject to any encumbrances, the authorised officer may, if he thinks fit, allow the purchaser to deposit with him the money required to discharge the encumbrances and any interest due thereon together with such additional amount that may be sufficient to meet the contingencies or further cost, expenses and interest as may be determined by him.

(8) On such deposit of money for discharge of the encumbrances, the authorised officer may issue or cause the purchaser to issue notices to the persons interested in or entitled to the money deposited with him and take steps to make the payment accordingly.
(9) The authorised officer shall deliver the property to the purchaser free from encumbrances known to the secured creditor on deposit of money as specified in sub-rule (7) above.

(10) The certificate of sale issued under sub-rule (6) shall specifically mention that whether the purchaser has purchased the immovable secured asset free from any encumbrances known to the secured creditor or not.

10. Appointment of Manager
(1) The Board of Directors or Board of Trustees, as the case may be, may appoint in consultation with the borrower any person (hereinafter referred to as the Manager) to manage the secured assets the possession of which has been taken over by the secured creditor.
(2) The Manager appointed by the Board of Directors or Board of Trustees, as the case may be, shall be deemed to be an agent of the borrower and the borrower shall be solely responsible for the commission or omission of acts of the Manager unless such commission or omission are due to improper intervention of the secured creditor or the authorised officer.
(3) The Manager shall have power by notice in writing to recover any money from any person who has acquired any of the secured assets from the borrower, which is due or may become due to the borrower.
(4) The Manager shall give such person who has made payment under subrule (3) a valid discharge as if he has made payments to the borrower.

(5) The manager shall apply all the monies received by him in accordance with the provisions contained in sub-section (7) of section 13 of the Ordinance.

11. Procedure for Recovery of shortfall of secured debt.

(1) An application for recovery of balance amount by any secured creditor pursuant to sub-section (10) of section 13 of the Ordinance* shall be presented to the Debts Recovery Tribunal in the form annexed as Appendix-VI to these rules by the authorised officer or his agent or by a duly authorised legal practitioner, to the Registrar of the Bench within whose jurisdiction his case falls or shall be sent by registered post addressed to the Registrar of Debts Recovery Tribunal.

(2) The provisions of the Debts Recovery Tribunal (Procedure) Rules, 1993 made under Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (51 of 1993), shall mutatis mutandis apply to any application filed by under sub-rule (1).

(3) An application under sub-rule (1) shall be accompanied with fee as provided in rule 7 of the Debts Recovery Tribunal (Procedure) Rules, 1993.

(19) RESERVE BANK OF INDIA GUIDANCE NOTES FOR SECURITISATION COMPANIES AND RECONSTRUCTION COMPANIES

'The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002' had come into effect from June 21, 2002. In exercise of the powers conferred therein, the Bank has framed Guidelines and Directions to Securitisation Companies and Reconstruction Companies relating to registration and other matters like acquisition of financial assets, prudential norms relating to income recognition, classification of assets, provisioning, accounting standards, capital adequacy, measures for asset reconstruction and deployment of funds.

2. The Bank has evolved a set of instructions which are required to be complied with by all Securitisation Companies or Reconstruction Companies so that the process of asset reconstruction proceeds on smooth and sound lines. In addition, the Bank has evolved guidance note based on guidelines issued on various matters, gist of which is given below for the guidance of securitization companies or reconstruction companies. The words and expressions used in these notes shall have the same meaning as in the Act.

(1) Acquisition of Financial Assets

i) Every securitization company or reconstruction company is required to evolve Asset Acquisition Policy within 90 days of getting the certificate of registration which shall, inter alia, provide that the transactions will take place in a transparent manner and at a fair price in a well informed market, and the transactions are executed on arm's length basis by exercise of due diligence.

ii) The share of financial assets to be acquired from the bank /FI should be appropriately and objectively worked out keeping in view the provision in the Act requiring consent of secured creditors holding not less than 75% of the amount outstanding to a borrower for the purpose of enforcement of security interest;

(iii) For easy and faster realisability, all the financial assets due from a single debtor to various banks / FIs may be considered for acquisition. Similarly, financial assets having linkages to the same collateral may be considered for acquisition to ensure relatively faster and easy realisation.

iv) Both fund and non-fund based financial assets may be included in the list of assets for acquisition. Standard Assets in the books of originator likely to face distress prospectively may also be acquired;

v) Acquisition of funded assets should not include takeover of outstanding commitments, if any, of any bank/FI to lend further. Terms of acquisition of security interest in non-fund transactions, should provide for the relative commitments to continue with bank/FI, till demand for funding arises.

vi). Loans not backed by proper documentation should be avoided.

vii). As far as possible, the valuation process should be uniform for assets of same profile and should ensure that the valuation of the financial assets is done in scientific and objective manner. Valuation may be done internally or by engaging an independent agency, depending upon the value of the assets. Ideally, valuation may be entrusted to the committee authorised to approve acquisition of assets, which may carry out the task in line with an Asset Acquisition Policy laid down by the board of directors in this regard.

viii). The assets acquired by SC/RC should be transferred to the trusts set up by the securitization company or reconstruction company at the price at which these were acquired from the originator of the asset. However, there is no restriction on acquisition of assets from banks/ FIs directly in the books of trusts set up by securitization company or reconstruction company.

ix). The assets acquired by the securitization company or reconstruction company are required to be resolved within a period which shall normally not exceed five years from the date of acquisition of such assets. However, if the assets remain unresolved at the end of five years from the date of acquisition, the Board of securitization company or reconstruction company may increase the period of realisation up to 8 years from the original date of acquisition of asset subject to conditions.

x). No securitization company or reconstruction company should acquire assets from another securitization company or reconstruction company as SC/RCs are not covered under the definition of ' financial institution' in the SARFAESI Act.

(2) Issue of security receipts

(i)Every securitization company or reconstruction company shall issue the security receipts through the trust set up exclusively for the purpose. The trusteeship of such trust shall vest with the securitization company or reconstruction company.

(ii) The trust shall issue security receipts only to qualified institutional buyers and such security receipts shall be transferable/ assignable only in favour of other qualified institutional buyers.

iii). Every securitization company or reconstruction company intending to issue security receipts shall make disclosures in the offer document as prescribed by the Bank from time to time.

iv). Every securitization company or reconstruction company shall invest in the security receipts issued by trusts set up for the purpose of securitization an amount not less than 5% under each scheme.

v). Every securitization company or reconstruction company shall continue to hold a minimum of 5% of the security receipts issued by the SC/RC under each scheme on an ongoing basis till the redemption of all the security receipts issued under each scheme.

vi). Qualified institutional buyers will be entitled to invoke the provisions of Section 7(3) of the SARFAESI Act at the end of 5 years or 8 years i.e as at the end of period of realisation applicable for the particular asset.

vi). Every securitization company or reconstruction company is required to declare Net Asset Value of the security receipts issued by it at periodical interval to enable the qualified institutional buyers to value their investment in SRs. For arriving at NAV, the SRs are required to be rated on 'recovery rating scale' and the rating agencies are also required to disclose the rationale for rating.

3. Application of prudential norms

i) Every securitization company or reconstruction company is required to maintain, on an ongoing basis a capital adequacy ratio which shall not be less than 15% of its total risk weighted assets.

ii) Every securitization company or reconstruction company is required to classify the assets as standard assets or non- performing assets after taking into account the period of delinquency and other weaknesses having bearing on the realisability of the asset. Such companies are also required to make provisions against the non- performing assets as specified by the Bank from time to time. The classification / provisioning norms will apply only to those assets which are held on the books of securitization company or reconstruction company.

iii). 'Loss Assets' will include financial assets including security receipts continued to be held by the securitization company or reconstruction company which has not been realized within the total time frame of 5 years or 8 years, as the case may be.

iv) A securitization company or reconstruction company may invest in equity of another securitization company or reconstruction company or may deploy its surplus funds only in Government securities or as deposits with scheduled commercial banks/ SIDBI/ NABARD/ other such entity as may be specified by RBI from time to time.

v). No securitization company or reconstruction company shall invest in land and building except for its own use up to 10% of the owned fund of the company. However, if any land and building is acquired by SC/RC in the ordinary course of its business of reconstruction while enforcing the security interest, such land and building shall be disposed of within a period of 5 years from the date of its acquisition or such extended time as may be permitted by the Bank.

vi) The income recognition shall be based on recognized accounting principles and all the accounting standards and guidance notes issued by ICAI shall be followed by securitization company or reconstruction company in so far as they are not inconsistent with guidelines and directions issued by the Bank.

(4) Approval of Policy Documents by the Board of Directors

Every securitization company or reconstruction company shall frame Policy Guidelines with the approval of their Board of Directors on issues relating to asset acquisition, rescheduling of debt due from borrowers, settlement of debt payable by the borrowers, issue of security receipts and policy regarding deployment of surplus funds. The policy relating to acquisition of financial assets is required to be evolved within 90 days of grant of certificate of registration to securitization company or reconstruction company. Every securitization company or reconstruction company shall maintain a record indicating therein the details of deviations made from the prescriptions of the Board of Directors in the matter of asset acquisition, pricing, etc. and the reasons therefor should be maintained.

(5) Regulatory Reporting.

(i) Every securitization company or reconstruction company is required to submit quarterly statement viz. SCRC1 & SCRC 2 to the Bank within 15 days of close of the quarter to which it pertains indicating therein, inter-alia, owned fund position, value of assets acquired, security receipts issued/ outstanding, investment in security receipts by various QIBs, list of banks/ FIs from whom the assets were acquired by securitization company or reconstruction company etc.

ii) Every securitization company or reconstruction company is required to furnish to the Bank a copy of the audited balance sheet along with directors'/ auditors' report within one month from the date of AGM in which the audited accounts of securitization company or reconstruction company are adopted.

(6) Internal Audit

To ensure functioning of securitisation companies or reconstruction companies on healthy lines, the operations and activities of such companies may be subjected to periodic audit and checks by internal / external agencies.

(7) Accounting year/ Disclosures in the balance sheet.

Every securitization company or reconstruction company shall prepare its balance sheet and profit and loss account as on March 31 every year. In addition to complying with requirements of Schedule VI of the Companies Act, 1956, the securitization company or reconstruction company shall make additional disclosures on various issues as listed in para 15 of the notification No. 2 dated April 23, 2003 as amended from time to time.

(20) THE SECURITISATION COMPANIES AND RECONSTRUCTION COMPANIES (RESERVE BANK) GUIDELINES AND DIRECTIONS, 2003

Notification No. DNBS.2/CGM(CSM)-2003 dated April 23, 2003

The Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003

The Reserve Bank of India, having considered it necessary in the public interest, and being satisfied that, for the purpose of enabling the Reserve Bank to regulate the financial system to the advantage of the country and to prevent the affairs of any Securitisation Company or Reconstruction Company from being conducted in a manner detrimental to the interest of investors or in any manner prejudicial to the interest of such Securitisation Company or Reconstruction Company, it is necessary to issue the guidelines and directions relating to registration, measures of asset reconstruction, functions of the company, prudential norms, acquisition of financial assets and matters related thereto, as set out below, hereby, in exercise of the powers conferred by Sections 3, 9, 10 and 12 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, issues to every Securititsion Company or Reconstruction Company, the guidelines and directions hereinafter specified.

Short title and commencement

1. (1) These guidelines and directions shall be known as 'The Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003'.

(2) They shall come into force with effect from April 23, 2003 and any reference in these guidelines and directions to the date of commencement thereof shall be deemed to be a reference to that date.

Applicability of the Directions

2. The provisions of these guidelines and directions shall apply to Securitisation Companies or Reconstruction Companies registered with the Reserve Bank of India under Section 3 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002. However, in respect of the trust/s mentioned in paragraphs 8 herein, the provisions of paragraphs 4, 5, 6,9, 10(i), 10(iii) 12,13,14 and 15 shall not be applicable.

3. Definitions

(1) (i) "Act" means the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;

(ii) "Bank" means the Reserve Bank of India constituted under Section 3 of the Reserve Bank of India Act, 1934;

[1][(iii) "Date of acquisition" means the date on which the ownership of financial assets is acquired by Securitisation Company or Reconstruction Company either on its own books or directly in the books of the trust;]

(iv) "Deposit" means deposit as defined in the Companies (-Acceptance of Deposits) Rules 1975 framed under Section 58 A of the Companies Act, 1956;

(v) Fair value means the mean of the earning value and the break up value;

(vi) “Non-performing Asset” (NPA) means an asset in respect of which:

a) Interest or principal (or instalment thereof) is overdue for a period of 180 days or more from the date of acquisition or the due date as per contract between the borrower and the originator, whichever is later;

b) interest or principal (or instalment thereof) is overdue for a period of 180 days or more from the date fixed for receipt thereof in the plan formulated for realisation of the assets referred to in paragraph 7(1)(6) herein;

c) interest or principal (or instalment thereof) is overdue on expiry of the planning period, where no plan is formulated for realisation of the assets referred to in paragraph 7(1)(6) herein; or

d) any other receivable, if it is overdue for a period of 180 days or more in the books of the Securitisation Company or Reconstruction Company.

Provided that the Board of Directors of a Securitisation Company or Reconstruction Company may, on default by the borrower, classify an asset as a non-performing asset even earlier than the period mentioned above (for facilitating enforcement as provided for in Section 13 of the Act).

(vii) “Overdue” means an amount which remains unpaid beyond the due date;

(viii) “Owned Fund” means the aggregate of paid up equity capital, paid up preference capital to the extent it is compulsorily convertible into equity capital, free reserves (excluding revaluation reserve), credit balance in Profit and Loss Account as reduced by the debit balance on the profit and loss account and Miscellaneous Expenditure (to the extent not written off or adjusted), book value of intangible assets and under / short provision against NPA / diminution in value of investments, and over recognition of income, if any; and further reduced by the book value of the shares acquired in a Securitisation Company or Reconstruction Company, and other deductions required on account of the items qualified by the auditors in their report on the financial statements;

(ix) "Planning period" means a period not exceeding twelve months allowed for formulating a plan for realization of non-performing assets (in the books of the originator) acquired for the purpose of reconstruction;

(x) “Standard asset” means an asset, which is not an NPA.

(xi) "Trust" means trust as defined in Section 3 of the Indian Trusts Act, 1882.

(2) Words or expressions used but not defined herein and defined in the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, shall have

the same meaning as assigned to them in that Act. Any other words or expressions not defined in that Act shall have the same meaning as assigned to them in the Companies Act, 1956.

4. Registration and matters incidental thereto

[2][(i) Every Securitisation Company or Reconstruction Company shall apply for registration in the form of application specified vide Notification No.DNBS.1/CGM(CSM)-2003 dated March 7, 2003 and obtain a certificate of registration from the Bank as provided under Section 3 of the Act;]

(ii) A Securitisation Company or Reconstruction Company, which has obtained a certificate of registration issued by the Bank under Section 3 of the Act, can undertake both securitisation and asset reconstruction activities;

[3] [(ii) (a) A Securitisation Company or Reconstruction Company shall commence business within six months from the date of grant of Certificate of Registration by the Bank;

Provided that on the application by the Securitisation Company or Reconstruction Company, the Bank may grant extension for such further period, not exceeding one year in aggregate from the date of grant of Certificate of Registration.

(ii) (b) A Securitisation Company or Reconstruction Company, which has obtained a Certificate of Registration from the Bank under Section 3 of the Act and not commenced business as on the date of the Notification shall commence business within six months from the date of Notification."]

[4][(ii) (c) Provisions of section 45 -IA, 45-IB and 45-IC of RBI Act,1934 shall not apply to non-banking financial company, which is a securitisation company or reconstruction company registered with the Bank under Section 3 of the SARFAESI Act,2002].

(iii) Any entity not registered with the Bank under Section 3 of the Act may conduct the business of securitisation or asset reconstruction outside the purview of the Act.

5 Owned Fund

Every Securitisation Company or Reconstruction Company seeking the Bank's registration under Section 3 of the Act, shall have a minimum Owned Fund of Rs. 2 crore.

[5][Provided that every Securitisation company or reconstruction company seeking the Bank's registration under Section 3, or carrying on business on commencement of the Securitisation Companies and Reconstruction Companies (Reserve Bank) (Amendment) Guidelines and Directions, 2004, shall have a minimum Owned Fund not less than fifteen percent of the total financial assets acquired or to be acquired by the Securitisation Company or Reconstruction Company on an aggregate basis, or Rs. 100 crore, whichever is less;

Provided further that –

(i) the minimum Owned Fund for any Securitisation Company or Reconstruction Company shall in no case be less than Rs two crore;

(ii) a Securitisation Company or Reconstruction Company carrying on business on the commencement of the Securitisation Companies and Reconstruction Companies (Reserve Bank) (Amendment) Guidelines and Directions, 2004 shall reach the level of minimum Owned Fund specified in the first proviso within three months from such commencement;

(iii) while computing the amount for the purpose of the first proviso, no account shall be taken whether the assets are transferred to a trust set up for the purpose of Securitisation or not;

(iv) the amount shall be continued to be held by the Securitisation Company or Reconstruction Company until realisation of assets and redemption of security receipts issued against such assets;

[6][(v) the Securitisation Company or Reconstruction Company shall invest in the security receipts issued by the trust set up for the purpose of securitisation, an amount not less than 5% under each scheme:

provided further that-

a Securitisation Company or Reconstruction Company which has already issued the security receipts shall achieve the minimum subscription limit in security receipts under each scheme within a period of six months from the date of the Notification.]

[7][(vi) the Securitisation Company or Reconstruction Company shall continue to hold a minimum of 5% of the Security Receipts of each class issued by the SC/RC under each scheme on an ongoing basis till the redemption of all the Security Receipts issued under such scheme.]

6. Permissible Business

(i) A Securitisation Company or Reconstruction Company shall commence/undertake only the securitisation and asset reconstruction activities and the functions provided for in Section 10 of the Act.

(ii) A Securitisation Company or Reconstruction Company, which is carrying on any other business, shall cease to do such business by June 20, 2003;

(iii) A Securitisation Company or Reconstruction Company shall not raise monies by way of deposit.

7 Asset Reconstruction

(1) Acquisition of Financial Assets

(i) Every Securitisation Company or Reconstruction Company shall frame with the approval of its Board of Directors, a 'Financial Asset Acquisition Policy', within 90 days of grant of Certificate of Registration, which shall clearly lay down the policies and guidelines covering, inter alia,

[8][(a) norms and procedure for acquisition either on its own books or directly in the books of the trust;]

(b) types and the desirable profile of the assets;

(c) valuation procedure ensuring that the assets acquired have realisable value which is capable of being reasonably estimated and independently valued;

(d) in the case of financial assets acquired for asset reconstruction, the broad parameters for formulation of plans for their realisation.

(ii) The Board of Directors may delegate powers to a committee comprising any director and/or any functionaries of the company for taking decisions on proposals for acquisition of financial assets;

(iii) Deviation from the policy should be made only with the approval of the Board of Directors.

[9][(2) (i) Change in or take Over of Management

The Securitisation Company or Reconstruction Company shall take the measures specified in Sections 9(a) of the Act, in accordance with instructions contained in Circular DNBS/PD (SC/RC) No. 17 /26.03.001/2009-10 dated April 21, 2010 as amended from time to time.

(ii) Sale or Lease of a part or whole of the business of the borrower

No Securitisation Company or Reconstruction Company shall take the measures specified in Section 9(b) of the Act, until the Bank issues necessary guidelines in this behalf.]

(3) Rescheduling of Debts

(i) Every Securitisation Company or Reconstruction Company shall frame a policy, duly approved by the Board of Directors, laying down the broad parameters for rescheduling of debts due from borrowers;

(ii) All proposals should be in line with and supported by an acceptable business plan, projected earnings and cash flows of the borrower;

(iii) The proposals should not materially affect the asset liability management of the Securitisation Company or Reconstruction Company or the commitments given to investors;

(iv) The Board of Directors may delegate powers to a committee comprising any director and/or any functionaries of the company for taking decisions on proposals for reschedulement of debts;

(v) Deviation from the policy should be made only with the approval of the Board of Directors.

(4) Enforcement of Security Interest

While taking recourse to the sale of secured assets in terms of Section 13(4) of the Act, a Securitisation Company or Reconstruction Company may itself acquire the secured assets, either for its own use or for resale, only if the sale is conducted through a public auction.

(5) Settlement of dues payable by the borrower

(i) Every Securitisation Company or Reconstruction Company shall frame a policy duly approved by the Board of Directors laying down the broad parameters for settlement of debts due from borrowers;

(ii) The policy may, interalia, cover aspects such as cut-off date, formula for computation of realisable amount and settlement of account, payment terms and conditions, and borrower's capability to pay the amount settled;

(iii) Where the settlement does not envisage payment of the entire amount agreed upon in one installment, the proposals should be in line with and supported by an acceptable business plan, projected earnings and cash flows of the borrower;

(iv) The proposal should not materially affect the asset liability management of the Securitisation Company or Reconstruction Company or the commitments given to investors;

(v) The Board of Directors may delegate powers to a committee comprising any director and/or any functionaries of the company for taking decisions on proposals for settlement of dues;

(vi) Deviation from the policy should be made only with the approval of the Board of Directors.

(6) Plan for realisation

(i) Every Securitisation Company or Reconstruction Company may, within the planning period, formulate a plan for realisation of assets, which may provide for one or more of the following measures:

(a) Rescheduling of payment of debts payable by the borrower;

(b) Enforcement of security interest in accordance with the provisions of the Act;

(c) Settlement of dues payable by the borrower;

(d) Change in or take over of the management, or sale or lease of the whole or part of business of borrower after formulation of necessary guidelines in this behalf by the Bank as stated in paragraph 7(2) herein above.

[10][(ii) Securitisation Company or Reconstruction Company shall formulate the policy for realisation of financial assets under which the period for realisation shall not exceed five years from the date of acquisition of the financial asset concerned.

(iii) The Board of Directors of the Securitisation Company or Reconstruction Company may increase the period for realisation of financial assets so that the total period for realisation shall not exceed eight years from the date of acquisition of financial assets concerned.

(iv) The Board of Directors of the Securitisation Company or Reconstruction Company shall specify the steps that will be taken by the Securitisation Company or Reconstruction Company to realise the financial assets within the time frame referred to in clause (ii) or (iii) as the case may be.

(v) The Qualified Institutional Buyers shall be entitled to invoke the provisions of Section 7(3) of the Act only at the end of such extended period, if the period for realisation is extended under clause (iii)].

8 Securitisation

[11][(1) *Issue of Security Receipts*- A Securitisation company or Reconstruction company shall give effect to the provisions of sections 7(1) and (2) of the Act through one or more trusts set up exclusively for the purpose. The Securitisation company or Reconstruction company shall transfer the assets to the said trusts at the price at which those assets were acquired from the originator if the assets are not acquired directly on the books of the trust:-]

(i) The trusts shall issue Security Receipts only to qualified institutional buyers; and hold and administer the financial assets for the benefit of the qualified institutional buyers;

(ii) The trusteeship of such trusts shall vest with the Securitisation Company or Reconstruction Company;

(iii) A Securitisation Company or Reconstruction Company proposing to issue Security Receipts, shall, prior to such an issue, formulate a policy, duly approved by the Board of Directors, providing for issue of security receipts under each scheme formulated by the trust;

(iv) The policy referred to in sub-paragraph (iii) above shall provide that the security receipts issued would be transferable / assignable only in favour of other qualified institutional buyers.

(2) Disclosures

Every Securitisation Company or Reconstruction Company intending to issue Security Receipts shall make disclosures as mentioned in the annexure.

9. Requirement as to capital adequacy

(1) Every Securitisation Company or Reconstruction Company shall maintain, on an ongoing basis, a capital adequacy ratio, which shall not be less than fifteen percent of its total risk weighted assets. The risk-weighted assets shall be calculated as the weighted aggregate of on balance sheet and off balance sheet items as detailed hereunder: Weighted risk assets

On-Balance Sheet items	**Percentage risk weight**
(a) Cash and deposits with scheduled ;commercial banks	0
(b) Investments in Government securities	0
(c) Other assets	100
Off- Balance Sheet Items	
All Contingent Liabilities	50

(2) Shares held in other Securitisation Companies or Reconstruction Companies shall not attract any risk weight.

10. Deployment of Funds

(i) A Securitisation Company or Reconstruction Company, may as a sponsor and for the purpose of establishing a joint venture, invest in the equity share capital of a Securitisation Company or Reconstruction Company formed for the purpose of asset reconstruction;

[12][(ii) A Securitisation company or Reconstruction company may deploy any surplus funds available with it, in terms of a policy framed in this regard by its Board of Directors, only in Government securities and deposits with scheduled commercial banks, Small Industries Development Bank of India, National Bank for Agriculture and Rural Development or such other entity as may be specified by the Bank from time to time;]

[13][(iii) No Securitisation Company or Reconstruction Company shall, invest in land or building, -

Provided that the restriction shall not apply to investment by Securitisation Company or Reconstruction Company in land and buildings for its own use up to 10% of its owned fund,

Provided further that the restriction shall not apply to land and building acquired by the Securitisation Company or Reconstruction Company in satisfaction of claims in ordinary course of its business of reconstruction of assets in accordance with the provisions of SARFAESI Act."

Provided further that any land and/or building acquired by Securitisation Company or Reconstruction Company in the ordinary course of its business of reconstruction of assets while enforcing its security interest, shall be disposed of within a period of five years from the date of such acquisition or such extended period as may be permitted by the Bank in the interest of realization of the dues of the Securitisation Company or Reconstruction Company.]

11. Accounting Year

Every Securitisation Company or Reconstruction Company shall prepare its balance sheet and profit and loss account as on March 31 every year.

12. Asset Classification

(1) Classification'

(i) Every Securitisation Company or Reconstruction Company shall, after taking into account the degree of well-defined credit weaknesses and extent of dependence on collateral security for realisation, classify the assets [14][held in its own books] into the following categories, namely:

(a) Standard assets

(b) Non-Performing Assets.

(ii) The Non-Performing Assets shall be classified further as

(a) `Sub-standard asset' for a period not exceeding twelve months from the date it was classified as non-performing asset;

(b) `Doubtful asset' if the asset remains a sub-standard asset for a period exceeding twelve months;

[15][(c) 'Loss asset' if (A) the asset is non-performing for a period exceeding 36 months; (B) the asset is adversely affected by a potential threat of non-recoverability due to either erosion in the value of security or non-availability of security; (C) the asset has been identified as loss asset by the Securitization company or Reconstruction company or its internal or external auditor; or (D) the financial asset including Security Receipts is not realized within the total time frame specified in the plan for realization formulated by the Securitization company or Reconstruction company under Paragraph 7 (6) (ii) or 7 (6) (iii) and the Securitization company or Reconstruction company or the trust concerned continues to hold those assets].

(iii) Assets acquired by the Securitisation Company or Reconstruction Company for the purpose of asset reconstruction may be treated as standard assets during the planning period, if any.

(2) Asset Reconstruction : Renegotiated / Rescheduled assets

(i) Where the terms of agreement regarding interest and /or principal relating to standard asset have been renegotiated or rescheduled by a Securitisation Company or Reconstruction Company (other wise than during planning period) the asset concerned shall be classified as sub-standard asset with effect from the date of renegotiation / reschedulement or continue to remain as a doubtful asset as the case be.

(ii) The asset may be upgraded as a standard asset only after satisfactory performance for a period of twelve months as per the renegotiated / rescheduled terms.

(3) Provisioning requirements

Every Securitisation Company or Reconstruction Company shall make provision against Non Performing Assets, as under: -

Asset Category	**Provision Required**
Sub-standard Assets	A general provision of 10% of the outstanding;
Doubtful Assets	(i) 100% provision to the extent the asset is not covered by the estimated realisable value of security; (ii) In addition to item (i) above, 50% of the remaining outstanding.
Loss Assets	The entire asset shall be written off. (If, for any reason, the asset is retained in the books, 100% thereof shall be provided for).

13. Investments

All investments should be valued at lower of cost or realisable value. Where market rates are available, the market value would be presumed to be the realisable value and in cases where market rates are not available, the realisable value should be the fair value. However, investments in other registered Securitisation Company or Reconstruction Company shall be treated as long term investments and valued in accordance with the Accounting Standards and guidance notes issued by the Institute of Chartered Accountants of India.

14. Income recognition

(i) The income recognition shall be based on recognised accounting principles;

(ii) All the Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India shall be followed in so far as they are not inconsistent with the guidelines and directions contained herein;

(iii) Interest and any other charges in respect of all the NPAs shall be recognised only when they are actually realised. Any such unrealised income recognised by a Securitisation Company or Reconstruction Company before the asset became non-performing and remaining unrealised shall be derecognised.

15. Disclosures in the balance sheet

(1) Every Securitisation Company or Reconstruction Company shall, in addition to the requirements of schedule VI of the Companies Act, 1956, prepare the following schedules and annex them to its balance sheet:

(i) the names and addresses of the banks/financial institutions from whom financial assets were acquired and the value at which such assets were acquired from each such bank/financial institutions;

(ii) Dispersion of various financial assets industry-wise and sponsor-wise. (dispersion is to be indicated as a percentage to the total assets);

(iii) Details of related parties as per Accounting Standard and guidance notes issued by the Institute of Chartered Accountants of India and the amounts due to and from them; and

(iv) A statement clearly charting therein the migration of financial assets from standard to non-performing.

[16][(v) Value of financial assets acquired during the financial year either on its own books or in the books of the trust;

(vi) Value of financial assets realized during the financial year;

(vii) Value of financial assets outstanding for realization as at the end of the financial year;

(viii) Value of Security Receipts redeemed partially and the Security Receipts redeemed fully during the financial year;

(ix) Value of Security Receipts pending for redemption as at the end of the financial year;

(x) Value of Security Receipts which could not be redeemed as a result of non-realization of the financial asset as per the policy formulated by the Securitization company or Reconstruction company under Paragraph 7(6)(ii) or 7(6)(iii).

(xi) Value of land and/ or building acquired in ordinary course of business of reconstruction of assets (year wise).]

(2) (i) The accounting policies adopted in preparation and presentation of the financial statements shall be in conformity with the applicable prudential norms prescribed by the Bank.

(ii) Where any of the accounting policies is not in conformity with these directions, the particulars of departures shall be disclosed together with the reasons therefor and the financial impact on account thereof. Where such an effect is not ascertainable, the fact shall be so disclosed citing the reasons therefor.

(iii) An inappropriate treatment of an item in Balance Sheet or Profit and Loss Account cannot be deemed to have been rectified either by disclosure of accounting policies used or by disclosure in notes to balance sheet and profit and loss account.

16. Internal Audit

Every Securitisation Company or Reconstruction Company shall put in place an effective Internal Control System providing for periodical checks and review of the asset acquisition procedures and asset reconstruction measures followed by the company and matters related thereto.

17. Exemptions

The Bank may, if it considers necessary for avoiding any hardship to Securitisation Company or Reconstruction Company, or for any other just and sufficient reason exempt all Securitisation Companies or Reconstruction Companies or a particular Securitisation Company or Reconstruction Company or class of Securitisation Companies or Reconstruction Companies, from all or any of the provisions of these guidelines and directions either generally or for any specified period, subject to such conditions as the Bank may impose.

(1) Disclosure in Offer Document

A Relating to the Issuer of Security Receipts

i. Name, place of Registered Office, date of incorporation, date of commencement of business of the Securitisation Company or Reconstruction Company;

ii. Particulars of sponsors, shareholders, and a brief profile of the Directors on the Board of the Securitisation Company or Reconstruction Company with their qualifications and experience;

iii. Summary of financial information of the company for the last three years or since commencement of business of the company, which ever is shorter;

iv. Details of Securitisation / Asset Reconstruction activities handled, if any, in the last three years or since commencement of business, which ever is shorter.

B Terms of Offer

i. Objects of offer;

ii. Description of the instrument giving particulars relating to its form, denomination, issue price, etc together with an averment that the transferability of security receipts is restricted to the qualified institutional buyers;

iii. Arrangements made for management of assets and extent of management fee charged by Securitisation Company or Reconstruction Company;

iv. Interest rate / probable yield;

v. Terms of payment of principal / interest, date of maturity / redemption;

vi. Servicing and administration arrangement;

vii. Details of credit rating, if any, and a summary of the rationale for the rating;

viii. Description of assets being securitised,

ix. Geographical distribution of asset pool;

x. Residual maturity, interest rates, outstanding principal of the asset pool;

xi. Nature and value of underlying security, expected cash flows, their quantum and timing, credit enhancement measures;

xii. Policy for acquisition of assets and valuation methodology adopted;

xiii. Terms of acquisition of assets from banks /financial institutions;

xiv. Details of performance record with the Originators;

xv. Terms of replacement of assets, if any, to the asset pool;

xvi. Statement of risk factors, particularly relating to future cash flows and steps taken to mitigate the same;

xvii. Arrangements, if any, for implementing asset reconstruction measures in case of default

xviii. Duties of the Trustee;

xix. Specific asset reconstruction measures, if any, on which approvals will be sought from investors;

xx. Dispute Redressal Mechanism.

(2) Disclosure on quarterly basis

i. Defaults, prepayments, losses, if any, during the quarter;

ii. Change in credit rating, if any;

iii. Change in profile of the assets by way of accretion to or realisation of assets from the existing pool;

iv. Collection summary for the current and previous quarter;

v. Any other material information, which has a bearing on the earning prospects affecting the qualified institutional buyers;

List of amending Notifications:

1. Notification No. DNBS. 1/CGM(CSM)/2003 dated March 7,2003
2. Notification No. DNBS. 3/CGM(OPA)/2003 dated August 28 2003
3. Notification No. DNBS. 4/ED(SG)/-2004 dated March 29, 2004
4. Notification No. DNBS. 5/CGM(PK)/-2006 dated September 20, 2006
5. Notification No. DNBS. 6/CGM(PK)/-2006 dated October 19, 2006
6. Notification DNBS(PD-SC/RC) No. 7 /CGM (ASR)/-2010 dated April 21, 2010
7. Notification No. DNBS. PD(SC/RC). 8 /CGM (ASR) - 2010 dated April 21, 2010.
8. Notification No. DNBS.PD(SC/RC). 9 /CGM (ASR) - 2010 dated April, 21,2010

(21) PROFESSIONAL OPPORTUNITIES

1. Incorporation and registration with SEBI
2. Preparation of Risk mitigation policy
3. Concurrent audit
4. Management Audit
5. Legal due diligence and ROC search
6. Preparation of resolution strategy
7. Valuation of assets to be taken over
8. Statutory Audit under the companies Act 2013
9. Statutory/Regulatory compliance
10. Corporate advisory services
11. Investment advisory services to investors
12. Independent director on board
13. Drafting & vetting of legal documents
14. Maintenance of corporate and trust accounts

(22) PERFORMA FOR LEGAL DOCUMENTS

ASSIGNMENT AGREEMENT

Dated ________________

AMONGST________________________AND_____________(Name of SC/RC______________
As Originally Intended Purchaser and Confirming Party

AND_____________(Name of SC/RC_________________(in its capacity as Trustee of the _______ – ______Trust) as Assignee

THIS ASSIGNMENT AGREEMENT (hereinafter referred to as this "**Agreement**") made at ____________ this ___ day of ___________:

AMONGST

1. ____, a______________________ and having its registered office at________________________ (hereinafter referred to as the "**Seller**" / "**Assignor**", which expression shall, unless repugnant to the context or meaning thereof, be deemed to mean and include its successors) of the **FIRST PART;**

AND

2. ____, a company incorporated under the Companies Act, 1956 and registered as a securitisation and asset reconstruction company pursuant to Section 3 of the SRFAESI (as hereinafter defined), having its registered office at ____ ________________________ hereinafter referred to as the **"Originally Intended Purchaser"** or "**Confirming Party**" (which expression shall, unless it be repugnant to the context, be deemed to include its successors) of the **SECOND PART**.

3. ____, a company incorporated under the Companies Act, 1956 and registered as a securitisation and asset reconstruction company pursuant to Section 3 of the SRFAESI (as hereinafter defined), having its registered office at ____ ________________________ acting in its capacity as trustee of the _______– ________ Trust for the benefit of the holders of Security Receipts issued by the trustee thereunder (hereinafter referred to as the "**Assignee**", which expression shall, unless repugnant to the context or meaning thereof, be deemed to mean and include its successors and assigns) of the **THIRD PART.**

The Seller, the Originally Intended Purchaser and the Assignee are hereinafter individually referred to as a "**Party**" and collectively referred to as "**Parties**".

WHEREAS:

(A) The Assignee is the trustee of the ________ – __________ Trust, declared pursuant to the trust deed dated _________ executed by the Assignee (such deed hereinafter referred to as the **"Trust Deed"**), for the benefit of the holders of the Security Receipts issued by the trustee thereunder.
(B) The Originally Intended Purchaser is a securitisation and asset reconstruction company, registered as such pursuant to Section 3 of the SRFAESI.
(C) The Seller has, under certain Financing Documents entered into between the Seller and the Borrowers named therein, extended from time to time, certain Financial Assistance to the respective Borrowers.
(D) The Originally Intended Purchaser and the Seller have during their negotiations, evolved the understanding whereunder the Originally Intended Purchaser being a 'securitisation company' and 'reconstruction company' has emerged as the acquirer of the Loans. It is also clarified that the said Loans are required to be transferred by the Originally Intended Purchaser in its capacity as the Securitisation Company or Reconstruction Company to the trust set up for the benefit of the holders of the Security Receipts issued by the trustee thereunder.
(E) The Seller has accordingly agreed with the Originally Intended Purchaser to assign in favour of the Originally Intended Purchaser or its nominees, the Loans, disbursed under the aforesaid Financing Documents together with all its rights, title and interest in the Financing Documents and any underlying Security Interests, pledges and/or guarantees in respect of such Loans, and the Originally Intended Purchaser has to implement the arrangement as contained above, nominated the Assignee to purchase the Loans together with all the rights, title and interest of the Seller in the Financing Documents and any underlying Security Interests, pledges and/or guarantees in respect of such Loans, upon the terms and subject to the conditions hereinafter mentioned and as envisaged under Section 5(1)(b) of the SRFAESI.
(F) The Parties are desirous of setting forth the terms and conditions, representations, warranties, covenants, and principles relating to the assignment of the Loans and all the rights, title and interest under the Financing Documents and to the underlying Security Interests, pledges and / or guarantees in respect of such Loans by the Seller to the Assignee.

NOW THEREFORE, in consideration of mutual promises and undertakings herein contained and other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the Parties agree as follows:

1. DEFINITIONS AND INTERPRETATION

1.1 Definitions

All words and expressions, not otherwise defined hereunder, shall, unless the context otherwise requires, have the same meaning given to them in the SRFAESI. In this Agreement, unless the context otherwise requires, the following expressions shall have the meanings set out below:

Amounts Due means all amounts due and payable by each of the Borrowers to the Seller in respect of the Financial Assistance availed of, under the terms of its respective Financing Documents.

Applicable Law means any applicable statute, law, regulation, ordinance, rule, judgment, rule of law, order, decree, recovery certificate, clearance, approval, directive, guideline, policy, requirement, or other governmental restriction or any similar form of decision, or determination by, or any interpretation or administration of any of the foregoing by, any statutory or regulatory authority whether in effect in India as of the date of this Agreement or thereafter and in each case as amended.

Borrower means a Person to whom a Financial Assistance has been extended by the Seller under any of the Financing Documents as listed in Schedule 1 and includes any Person who has created any Security Interest and/or pledge to secure, including but not limited to and/or by mortgage of immovable properties as collateral securities and/or a guarantee in respect of, the repayment of any Financial Assistance granted by the Seller to a Borrower.

Business Day means a day which is not:

(a) a public holiday under Section 25 of the Negotiable Instruments Act, 1881 (26 of 1881) as applicable at respective places; or

(b) a Saturday or Sunday; or

(c) any other day when the clearing facility offered by the Reserve Bank of India is unavailable.

Collection and Payout Account means a bank account titled "___________________ Trust - Collection and Payout Account" opened and maintained by the Assignee at the bank notified by the Assignee to the Seller for this purpose from time to time, in which all the Amounts Due and any other monies recovered in respect of the Loans would be deposited.

Consent means any consent, license, approval, registration, permit or other authorisation of any nature, if any required to be granted by any Statutory Authority:

(i) for the incorporation of the Seller or the Assignee and fulfilling, under this Agreement and the Transaction Documents their respective obligations;

(ii) for the enforcement of this Agreement and any Transaction Documents and the making of any payments contemplated thereunder; and

(iii) for all such other matters as may be necessary in connection with this Agreement and/or the Transaction Documents or the performance of any Person's obligations under this Agreement and/or any Transaction Document.

Cut-off Date means ________, being the date with effect from which (including that day) all economic benefits pertaining to the Loans including all realizations and recoveries already made on and after said date shall be for the benefit of the Assignee and shall simultaneously with this Agreement be passed on to the Assignee.

Financing Documents means all the agreements, deeds and/or documents, executed in favour of the Seller and / or entered into between the Seller and any
Borrower and/or any third parties, *inter alia* setting out the terms and conditions on which the Seller has agreed to provide Financial Assistance to such Borrower, including any writings creating/evidencing a Security Interest, pledge and / or guarantee in favour of the Seller and any undertakings by any Person, on the basis of which the Seller disbursed or made available such Financial Assistance, a list of which agreements, deeds and/or documents is more particularly set out in Schedule 1 annexed hereto. The description of the movable/ immovable properties over

which Security Interests have been created in favour of the Sellers is as set out in Schedule 2 annexed hereto.

Loans means the aggregate of all Amounts Due and all other monies whatsoever stipulated in or payable, under the Financing Documents, by the Borrowers to the
Seller, including but not limited to past overdues, future payments, interest charges for delayed payments, indemnities and damages or other charges and/or all other monies, if any, received or to be received by the Seller under the Financing Documents, including the proceeds of any enforcement of the Financing Documents or any Security Interests and/or pledge, created by any Borrower to secure the repayment of the Financial Assistance under the Financing Documents and/or any guarantee issued in relation thereto.

Provided that it is hereby clarified that Amounts Due and all other monies stipulated in or payable, under the Financing Documents shall not include any undisbursed commitment by the Seller to any of the Borrowers under the Financing Documents.

Person means any individual, partnership, limited liability partnership, joint venture, firm, corporation, company, association, trust or other enterprise (whether incorporated or not) or Government (central, state or otherwise), sovereign, or any agency, department, authority or political sub-division thereof, international organisation, agency or authority (in each case, whether or not having separate legal personality) and shall include their respective successors and assigns and in case of an individual shall include his/her legal representatives, administrators, executors and heirs and in case of a trust shall include the trustee or the trustees for the time being.

Purchase Consideration means an amount of Rs. ___________________(Rupees ____________________ only), being the aggregate purchase consideration for the Loans.
SRFAESI means the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, and includes any rules, regulations, directions or guidelines issued thereunder from time to time, as the same may be amended, substituted or re-enacted from time to time.

Statutory Authority means any regulatory authority, or the Government of India,
or any regional or municipal authority thereof, or other central, state or local Government or any legislature, ministry, department, commission, board, authority, instrumentality, agency, political sub-division, corporation or commission under the direct or indirect control of the Government of India, or any State Government or any political sub-division of either of them, or the Reserve Bank of India as to matters of policy or otherwise, owned or controlled by the Government of India or any State Government or any of their subdivisions.

Transaction Documents means and includes without limitation, all agreements, instruments, undertakings, indentures, deeds, writings and other documents (whether financing, security or otherwise) executed or entered into, or to be executed or entered into, by the Seller, the Assignee or any other Person in relation, or pertaining, to the transactions contemplated by or under this Agreement. When the term 'Transaction Document' is used with reference to the Seller, the Assignee or any other Person, such term shall refer to a Transaction Document that the Seller, the Assignee or such other Person, as the case may be, has furnished, or is party to.

Trust Deed has the meaning given to such term in Recital (A).

1.2 Interpretation
In this Agreement, unless the context otherwise requires:

(a) words of any gender are deemed to include the other gender;
(b) words using the singular or plural number also include the plural or singular number, respectively;
(c) the terms “hereof”, “herein”, “hereby”, “hereto” and any derivative or similar words refer to this entire Agreement;
(d) the terms “Section” “sub-section” and “Schedule” refer to a section, subsection or schedule of this Agreement;
(e) headings, sub-headings and bold typeface are only for convenience and shall be ignored for the purposes of interpretation;
(f) reference to any legislation or law or to any provision thereof shall include references to any such legislation or law as it may, after the date hereof, from time to time, be amended, supplemented or re-enacted, and any reference to a statutory provision shall include any subordinate legislation made from time to time under that provision;
(g) any term or expression used, but not defined herein, shall have the same meaning assigned thereto under Applicable Law;
(h) references to the word “include” or “including” shall be construed without limitation;
(i) each of the representations and warranties contained in Section 4.1 hereof shall be separate and independent and shall not be limited by reference to any other Section or by anything in this Agreement; and
(j) the schedules annexed to this Agreement form an integral part of this Agreement and will be of full force and effect as though they were expressly set out in the body of the Agreement.

2. ASSIGNMENT OF LOANS

2.1 Assignment

2.1.1 The Parties hereto acknowledge that the conditions precedent set forth in Section 3 (*Conditions Precedent*) have been fulfilled or waived by the Assignee, as the case may be, and in consideration of the Assignee, paying the Purchase Consideration to the Seller, and upon the terms and conditions set forth herein and
in the relevant Transaction Documents, the Seller as the true, legal and beneficial owner of the Loans, in the ordinary course of its business, at the specific request of the Originally Intended Purchaser, hereby unconditionally and irrevocably sells, assigns, transfers and releases to and unto the Assignee all the Loans forever, pursuant to Section 5(1) (b) of the SRFAESI TO HOLD the same absolutely IN TRUST for the benefit of the holders of the Security Receipts issued by the Assignee pursuant to the __________ – __________ Trust, and the Trust Deed TO THE END AND INTENT THAT the Assignee shall hereafter be deemed to be the full and absolute legal owner, and the only person legally entitled to the Loans or any part thereof, free from any or all encumbrances, and to recover and receive all Amounts Due, including the right to file a suit or institute such other recovery proceedings and take such other action as may be required for the purpose of recovery of the Loans, in its own name and right and as an assignee, and not as a representative or agent of the Seller and to exercise all other rights of the Seller in relation thereto.

2.1.2 The Seller at the specific request of the Originally Intended Purchaser, hereby further assigns in favour of the Assignee, all its rights, title and interest in the Financing Documents, all agreements, deeds and documents related thereto and all collateral and underlying Security

Interests and / or pledges created to secure, and/or guarantees issued in respect of, the repayment of the Loans, which the Seller is entitled to. The Assignee shall have the right to enforce such Security Interests, pledges and / or guarantees and appropriate the amounts realized there from towards the repayment of the Loans and to exercise all other rights of the Seller in relation to such Security Interests, pledges and / or guarantees. The Seller shall transfer/deliver or cause to be transferred/delivered or hold for and on behalf of the Assignee, all such original documents, deeds and/or writings, including but not limited to the Financing Documents, and produce the same promptly upon any request by the Assignee.

2.1.3 The Seller hereby agrees with the Originally Intended Purchaser and the Assignee, that it shall execute all documents as may be necessary or required for the purpose of perfecting the Assignee's right, title and interest in the Loans, the Financing Documents, and/or any underlying Security Interests, pledges and / or guarantees as the case may be, unto and to the use of the Assignee in the manner aforesaid, determined by the Assignee in its sole discretion, and do all acts, deeds and things as may be necessary in this regard, at the cost of the Assignee.

2.1.4 Upon execution of these presents, the Purchase Consideration shall be paid by the Assignee to the Seller by way of electronic funds transfer or remittance of funds by any other means crediting the Account No. ________________________ of the Seller.

2.1.5 The Seller shall, upon receipt of the Purchase Consideration, forthwith hand over a receipt to the Assignee, duly acknowledging the payment of the Purchase Consideration. The payment of the Purchase Consideration to the Sellers shall constitute full, final and complete discharge of the obligation of the Assignee with respect to payment of consideration for the Loans and the Assignment stated herein taking effect. The Seller hereby admits and acknowledges the sufficiency of the Purchase Consideration.

2.2 Further Actions

2.2.1 Any payment by any Borrower in discharge of the Loans, to the Assignee, into the Collection and Payout Account or into the hands of the duly authorised agent of the Assignee, shall constitute a discharge of its/their obligations to the Seller and the Assignee, to make such payments.

2.2.2 In the event that either the Seller or Assignee receives payment from any Borrower in connection with the Financial Assistance availed by such Borrower from the Seller (including, but not limited to, the Loans), without specific reference to the Financial Assistance in respect to which such payments relate, then the Seller or the Assignee, as the case may be, shall ascertain from such Borrower, the specific Financial Assistance in respect of which such payment has been made by such Borrower. Each of the Parties hereby agrees that in the event that it receives any amounts pertaining to the Financial Assistance held by the other Party, or any part thereof, after the cut-off date pending execution of this Agreement, it shall hold such amounts, or part thereof, as the case may be, free of any set off or counterclaim, in trust for the benefit of the other Party and shall forthwith, upon receipt thereof, hand such amounts over to the other Party or its duly authorised agent.

2.2.3 Each of the Parties hereby agrees that all payments that are required to be made by it to the other Party under this Agreement shall be made in full without exercising any right of set-off.

2.2.4 Save and except as provided for under this Agreement, the Seller shall not have, and hereby irrevocably waives any separate claim against any Borrower, in respect of the Loans.

2.2.5 The Seller hereby undertakes that it shall, if so required by the Assignee, notify any or all the Borrowers, Guarantors, Advocates, other Lenders, Statutory Authorities, DRT/DRAT/High Court/BIFR/AAIFR, Official Liquidator, High Court/DRT Receiver, Insurance Company, Security Agency and any other entity related to the borrower of the assignment of the Loans the underlying Security Interests, pledges and / or guarantees and all its right, title and interest in the Financing Documents to the Assignee.

2.2.6 In the event of delay on the part of a Party in making payments to the other Party as contemplated in this Agreement (including by way of indemnity), such Party shall without prejudice to the rights of the other Party under this Agreement pay the defaulted amounts together with simple interest thereon at the rate of 9 % per annum computed with monthly rests from the date on which such amounts become due and payable till the date of actual payment.

3. CONDITIONS PRECEDENT

The Seller shall have procured and handed over the following to the Assignee, prior to the execution of this Agreement:

(a) Copies of the constitutional documents of the Seller and all appropriate authorisations, approving the execution by the Seller of this Agreement and the transactions contemplated hereunder and the other documents to be delivered by it; and

(b) A certificate from the Seller certifying (a) the names and signatures of the officers authorised on behalf of the Seller to execute this Agreement and any other documents to be delivered by it hereunder, and (b) the authenticity of the constitutional documents of the Seller and the authorisations provided by it in terms of Section 3 (a) above.

4. SELLER'S REPRESENTATIONS AND WARRANTIES

4.1 The Seller hereby represents and warrants to the Assignee that, as on the date of this Agreement and with reference to the facts and circumstances then existing: -

(a) the Seller is a bank/financial institution duly organised, validly existing and in good standing under Applicable Law and is duly qualified and licensed to do business in each jurisdiction in which the character of its properties or the nature of its activities requires such qualifications;

(b) the Seller has full corporate power and authority to enter into this Agreement, the Financing Documents and the other Transaction Documents and to take any action and execute any documents required by the terms hereof and thereof respectively and that this Agreement, the Financing Documents and the other Transaction Documents entered into/to be entered into, as the case may be, have been duly authorised by all necessary corporate approvals, have been or will be, as the case may be, duly and validly executed and delivered by the Seller, and, assuming due authorisation, execution and delivery by the Assignee, is or will be the legal, valid and binding obligation of the Seller, enforceable in accordance with the terms hereof and thereof respectively; and that the executants of this Agreement, the Financing Documents and the other Transaction Documents, on behalf of the Seller, have been duly empowered and authorised to execute the same and to perform all its obligations in accordance with the terms herein and therein; (c) the Loans are Non-Performing Assets and have been duly and validly classified as such, in accordance with the guidelines issued by the Reserve Bank of India in this regard and all Applicable Law, *provided* that in the event that the Reserve Bank of India finds that the Loans have been wrongly classified or have been transferred to the Assignee in contravention of the guidelines issued by the Reserve Bank of India from time to time, the Assignee shall have the right, at its sole discretion, to equire the Seller, in writing, to repurchase such Loans at the Purchase Consideration attributable to such Loans and upon such notice, the Seller and Assignee shall forthwith execute such documents as are necessary for such repurchase;

(d) The loan documents are duly executed, stamped and not time barred.

(e) the recovery of the Loans or any part thereof, due from any Borrower is not time barred, except as disclosed by the Seller, in its letter dated _________, the receipt of which has been acknowledged by the Assignee;

(f) no Consent, approval, order, registration or qualification of, or with, any court or Statutory Authority having jurisdiction over the Seller, the absence of which, would adversely affect the legal and valid execution, delivery and performance by the Seller of this Agreement or the documents and instruments contemplated hereby or the taking by the Seller of any actions contemplated herein, is required;

(g) to the best of the knowledge of the Seller, none of the Borrowers is entitled to claim a right of set off in respect of its Loans;

(h) no right of set off has been exercised by any Borrower in respect of its Loans, except as disclosed by the Seller, in its letter dated _________, the receipt of which has been acknowledged by the Assignee;

(i) neither the execution and delivery of the Financing Documents, this Agreement and the other Transaction Documents by the Seller, nor the consummation of the transactions contemplated hereby, nor the fulfillment of or compliance with the terms and conditions of the Financing Documents, this Agreement and the other Transaction Documents, conflict with or result in a breach of or a default under any of the terms, conditions or provisions of any legal restriction (including, without limitation, any judgment, order, injunction, decree, award, recovery certificate or ruling of any court or Statutory Authority, or any Applicable Law) or any covenant or agreement or instrument to which the Seller is now a party, or by which the Seller or any of the Seller's property is bound, nor does such execution, delivery, consummation or compliance violate or result in the violation of the Seller's Certificate of Incorporation, Memorandum of Association or Articles of Association and, except as disclosed by the Seller, in its letter dated ________________, the receipt of which has been acknowledged by the Assignee, the Financing Documents have been adequately stamped and registered, in accordance with Applicable Law and the executant of the Transaction Documents on behalf of the Seller, has been duly empowered and authorized to execute such Transaction Documents and all other documents and to perform all the obligations of the Seller in accordance with the terms set out herein;

(j) the ledger extracts setting out the details of the Loans, including the Amounts Due under the respective Financing Documents, which have been handed over to the Assignee by the Seller and receipt of the same acknowledged by the Assignee, are true and correct in all respects and have been prepared in accordance with Applicable Law;

(k) all information set forth herein, or in the Financing Documents and the other Transaction Documents, pertaining to the Borrowers is, to the best of
the knowledge and belief of the Seller, and pertaining to the Seller is, true and correct in all respects, and all names, addresses, amounts, dates, signatures and other statements and facts contained in the Financing Documents and pertaining to the Borrowers are, to the best of the

knowledge and belief of the Seller, and pertaining to the Seller are, genuine, true and correct in all respects;

(l) the Seller has not rescheduled, amended, or granted any relief to any Borrower, regarding any of the payment terms of any of the Financing Documents, other than:

(i) those that have been regularised by such Borrower subsequent tothe grant of such relief; and

(ii) those that have been disclosed by the Seller to the Assignee in its letter dated __________, the receipt of which has been acknowledged by the Assignee;

(m) each of the Loans has been provided by the Seller in the ordinary course of its business and the Seller confirms that cases classified as fraud do not form part of the Loans;

(n) none of the rights, title and interest of the Seller in the Financing Documents, the Loans and/or any underlying Security Interest, pledge or guarantee has been sold, assigned or pledged to any Person and the Seller has, good and marketable title to each of the Financing Documents, the Loans, and the underlying Security Interests, pledges and / or guarantees, free and clear of any encumbrance and the Seller is the sole legal and full beneficial owner thereof and has full and absolute right to irrevocably and unconditionally sell, transfer and assign the Financing Documents, the Loans and the underlying Security Interests, pledges and / or guarantees to the Assignee;

(o) with respect to each of the Financing Documents there is only one original and the same is in the possession of the Seller, except as disclosed by the Seller pursuant to its letter dated ___________ the receipt of which has been acknowledged by the Assignee;

(p) except as disclosed by the Seller, in its letter dated ______________, the receipt of which has been acknowledged by the Assignee, all documentation and the filing of all necessary forms, in relation to any Security Interest, pledge or guarantee created in respect of the Loans, under any Applicable Law, is adequate, valid, duly executed, complete and enforceable and valid and enforceable Security Interests, pledges and /or guarantees have been created in favour of the Seller;

(q) the Seller, in respect of the securities mentioned in schedule 2, has not released any Security Interest, pledge or guarantee in respect of the Loans before the date of this Agreement, except as disclosed by the Seller, in its letter dated _______________, the receipt of which has been acknowledged by the Assignee;

(r) there have been no payment defaults or defaults to the knowledge of the Seller as per the records available with the Seller, that may have a material adverse effect on the recovery of Amounts Due from the Borrowers under the Financing Documents, other than those defaults which have been expressly and in writing communicated by the Seller to the Assignee, in its letter dated _________, the receipt of which has been acknowledged by the Assignee;

(s) to the best of the knowledge of the Seller, no proceedings for winding up, bankruptcy or liquidation or distraint or attachment of any properties of any Borrower, or any action for the appointment of a receiver, liquidator, assignee (or similar official) for any part of its property, or any proceedings hampering the right of the Seller to enforce the Financing Documents or th underlying Security Interests, pledges and / or guarantees, including any proceedings before the

Board of Industrial and Financial Reconstruction/ Appellate Authority for Industrial and Financial Reconstruction, have been filed by any Person, other than as disclosed by
the Seller to the Assignee, in its letter dated ____________, the receipt of which has been acknowledged by the Assignee. The Seller further represents that where any winding up, bankruptcy or liquidation proceedings have been initiated against any Borrower of which the Seller has knowledge, and if:
(i) the Seller has opted to enforce its Security Interest, pledge and / or guarantee in relation to any Loan outside the winding up, the Seller has tak n all necessary actions for the preservation of such Security Interest and / or the underlying assets and for the recovery of the Loan, including appointment of a receiver, issuing of all necessary notices; or
(ii) the Seller has opted to relinquish its Security Interest, pledge and /or guarantee in relation to any Loan and prove for the claims in the winding up / liquidation proceedings, it has filed the claim for the same and taken all other necessary actions for the purpose of proving its claim in relation to the Loans and recovering all monies in relation thereto;

(t) the terms and conditions contained in the Financing Documents correctly reflect the entire agreement between parties thereto and there are no other oral or written agreements or representations in connection therewith and each Borrower has, to the best of the knowledge, information and belief of the Seller, entered into its Financing Documents of its own free will;

(u) to the best of the knowledge, information and belief of the Seller, each of the Financing Documents (including all documents creating any underlying Security Interests, pledges and / or guarantees) has been duly authorised, executed and delivered by the respective Borrower, complies with all Applicable Law and represents the legal, valid and binding irrevocable obligation of such Borrower, enforceable under all Applicable Laws against such Borrower in accordance with its terms (except to theextent that enforcement of remedies may be limited by applicable bankruptcy, insolvency or similar laws) and the executant of the Financing Documents on behalf of such Borrower, has been duly empowered and authorized to execute such Financing Documents and all other documents and to perform all the obligations of such Borrower, in accordance with the terms set out herein;

(v) no suits have been filed, or other proceedings initiated by the Seller against any Borrower before any court, tribunal, Statutory Authority or regulatory body other than those disclosed by the Seller to the Assignee, in its letter dated _______________, the receipt of which has been acknowledged by the Assignee;

(w) there are no agreements, deeds and/or documents other than those set out in Schedule 1 that would affect the ability of the Assignee to realise the Amounts Due in terms of the respective Financing Documents;

(x) other than as disclosed by the Seller to the Assignee, in its letter dated ____________, the receipt of which has been acknowledged by the Assignee, the e are no claims, suits, actions, administrative, arbitration or other proceedings or governmental investigations, including, without limitation, any counterclaims or claims by any Borrower or any Statutory Authority, pending or, to the best of knowledge of the Seller, threatened against the Seller, relating to any Financing Document, any Transaction Document, the Amounts Due or any other amounts payable in respect of the Loans or, the acquisition, collection or administration thereof. The Seller has not received any notice of, or to the knowledge of the Seller, is there any valid basis for, any claim or assertion of liability against the Seller, relating to any of the Financing Documents, any Transaction Document, the Amounts Due or any other amounts payable in respect of the Loans or

the acquisition, collection or administration thereof, other than as disclosed by the Seller to the Assignee in the said letter. The business of the Seller has not been the subject of any proceeding, nor to the best of knowledge of the Seller, has there been any investigation by or before any Statutory Authority in connection with the Seller's business practices with respect to any Financing Document, any Transaction
Document, the Amounts Due or the acquisition, collection or administration thereof; and

(y) the Financing Documents, in original, and all other related deeds and documents (including but not limited to any title deeds deposited by any Borrower in respect of the Loans disbursed under the relevant Financing Documents) have been furnished to the Assignee, and delivered, transferred to the Assignee or any agent of the Assignee or are being held to the order of the Assignee, as agreed by the Parties.

4.2 If any of the above representations is found to be incorrect , a consequence of which materially and adversely affects the interest of the Assignee in the related Loan, such misrepresentation shall be rectified by the Seller forthwith and in no event later than thirty (30) days from the date of receipt of notice by the Seller from the Assignee, to the satisfaction of the Assignee, after a notice in respect of the breach is given to the Seller by the Assignee.

4.3 All costs, charges and expenses (including stamp duty) incurred in connection with any rectification in accordance with Section 4.2 above, shall be borne in full by the Seller.

4.4 The representations and warranties of the Seller contained in this Agreement are true and correct as at the date hereof. The Seller acknowledges that the Assignee has acquired the Loans and entered into the Transaction Documents relying primarily on the representations and warranties and covenants of the Seller. The Seller represents and confirms that the Seller has disclosed all relevant information of which it has knowledge in relation to the loans acquired by the Assignee.

4.5 Except as otherwise specifically stated in this clause, each representation and warranty is made by the Seller with reference to the facts and circumstances existing as on the date of this Agreement.

5. ASSIGNEE'S REPRESENTATIONS AND WARRANTIES

The Assignee hereby represents and warrants to the Seller that, as on the date of this Agreement and with reference to the facts and circumstances then existing:

a) the Assignee is a limited liability company, duly organised, validly existing and in good standing under the laws of India, has obtained a certificate of registration as a securitisation and asset reconstruction company from the Reserve Bank of India, pursuant to Section 3 of the SRFAESI and is duly qualified and licensed to do business in each jurisdiction in which the character of its properties or the nature of its activities requires such qualifications;
b) the Assignee has full corporate power and authority to enter into this Agreement and the Transaction Documents and to take any action and execute any documents required by the terms thereof and that this Agreement and the Transaction Documents have been duly authorised by all necessary corporate proceedings, have been duly and validly executed and delivered by the Assignee, and are the legal, valid and binding obligation of the Assignee, enforceable in accordance with the terms thereof; and that the executant of this Agreement and the Transaction Documents, on behalf of the Assignee, has been duly empowered and

authorised to execute the same and to perform all its obligations in accordance with the terms herein and therein;

c) no Consent, approval, order, registration or qualification of, or with, any court or Statutory Authority having jurisdiction over the Assignee, the absence of which, would adversely affect the legal and valid execution, delivery and performance by the Assignee of this Agreement or the documents and instruments contemplated hereby or the taking by the Assignee of any actions contemplated herein, is required; and

d) neither the execution and delivery of this Agreement and the other Transaction Documents by the Assignee, nor the consummation of the transactions contemplated hereby or thereby, nor the fulfilment of, or compliance with, the terms and conditions of this Agreement and the other Transaction Documents, conflict with or result in a breach of or a default under any of the terms, conditions or provisions of any legal restriction (including, without limitation, any judgement, order, injunction, decree or ruling of any court or Statutory Authority, or any Applicable Law) or any covenant or agreement or instrument to which the Assignee is now a party, or by which the Assignee or any of the Assignee's property is bound, nor does such execution, delivery, consummation or compliance violate or result in the violation of the Assignee's Certificate of Incorporation, Memorandum of Association or Articles of Association.

e) Agrees that once this Agreement executed by the Seller in favour of the Assignee upon receipt of the consideration, all rights of the Seller in respect of the Transaction Documents and the Loans ceases and the Assignee shall not have any recourse thereafter against the Seller and the entire credit risks associated with the Financing Documents shall stand transferred to the Assignee on the execution of this Agreement.

6. SELLER'S COVENANTS

6.1 The Seller hereby agrees and undertakes irrevocably and unconditionally that as on the date of this Agreement with reference to the facts and circumstances then existing:-

(a) It shall execute, at the cost of the Assignee, such further documents, deeds and writings and to do such further acts, deeds or things as may be necessary or required (in the sole determination of the Assignee) to carry out and complete the transactions contemplated herein, and in the Transaction Documents, including any actions that may need to be taken on account of any change in Applicable Law and filing of all requisite forms in this behalf; however, such costs shall relate only to the original documents and shall not include the expenses to be incurred by the employees of the Seller Bank in relation to the transaction;

(b) it shall, at the cost of the Assignee, reasonably co-operate with the Assignee in any legal proceedings that may be necessary or incidental to the enforcement of the Loans or the underlying Security Interests, pledges and /or guarantees and will co-operate in any recovery proceedings with the Assignee through courts or otherwise;

(c) it shall make available to the Assignee, on request, all evidence (under the control and possession of the Seller) required by the Assignee in any proceedings and render all assistance as the Assignee may require, *provided that* the Assignee shall reimburse the Seller, at actuals, all costs incurred by it in this regard;

(d) it shall, upon the receipt of any payments from any Borrower with respect to the Loans assigned, as specifically indicated by such Borrower, by way of a negotiable instrument, forthwith, endorse such negotiable instrument in favour of the Assignee and hand the same over to the Assignee;

(e) it shall, as soon as it is aware, inform the Assignee of any breach of any of the representations or warranties contained in this Agreement.

6.2 The Assignee shall have the sole right of collecting any monies pertaining to the Loans, including the Amounts Due, enforcing the underlying Security Interests, pledges and / or guarantees and enforcing payment of all the Loans, in whatever manner it may consider necessary and prudent, in its absolute discretion.

7. INDEMNITIES

7.1 The Seller shall, within thirty (30) days from the receipt of notice thereof, indemnify and save harmless the Assignee, its successors and assigns, against any and all losses, damages, liabilities, suits, claims, counterclaims, actions, penalties, expenses (including any stamp duty, attorney's fees and court costs and any expenses incurred by the Assignee for the enforcement of this Section), which the Assignee shall suffer as a result of:

(a) any breach of the Seller's warranties, representations, covenants, undertakings or agreement contained herein; (b) any failure on the part of the Seller to observe or perform, in any respect, any covenant or obligation or undertaking (other than payment delay and/or default) under this Agreement or the Transaction Documents executed by it; or

(c) any claim made by any Borrower (for the purposes of this Section, referred to as a **"Claim"**) pursuant to which a court has passed an order and/or decree against the Assignee on account of any action or omission of the Seller in relation to the relevant Loans and/or such Borrower, including in relation to any undisbursed commitment of the Seller under the Financing Documents, prior to the date of this Agreement.

Provided that the liability of the Seller under (a) and (b) above shall not exceed the Purchase Consideration.

Provided further the Assignee shall notify the Seller of any Claims, within thirty (30) days of such Claim being made against the Assignee, providing full details (together with copies of all documents if any served on the Assignee). Upon such notification, the Seller shall have the right, at its own cost, to assume the defence of such Claim and the Assignee will, at the cost of the Seller, defend and/or take such action as the Seller reasonably requires for this purpose.

8. EXCLUSION OF LIABILITY OF ASSIGNEE

To the extent permitted by Applicable Law, the Assignee does not by virtue of entering into or carrying out the terms of this Agreement or purchasing the Loans assume any of the financial or pecuniary obligations of the Seller under any of the Financing Documents. Any such obligations, duties, warranties, indemnities and liabilities of the Seller under the Financing Documents shall be the sole responsibility of the Seller.

9. EFFECTIVE DATE OF AGREEMENT

This Agreement shall be effective from the day, month and year first hereinabove written.

10. CONFIRMATION BY ORIGINALLY INTENDED PURCHASER

The Originally Intended Purchaser hereby confirms the assignment of the Loans disbursed under the aforesaid Financing Documents together with all its rights, title and interest in the Financing Documents and any underlying Security Interests, pledges and/or guarantees in respect of such Loans.

11. MISCELLANEOUS

11.1 Notices

Any notice or other communication given pursuant to this Agreement must be in writing and (a) delivered personally, or (b) sent by facsimile transmission, or (c) sent by registered mail, postage prepaid, as follows:

To: Seller

Address: ____________________

Attention: ____________________

Fax: ____________________

To: Assignee

____,
as Trustee for the ___________ – __________ Trust
______________,
______________,
____
Attention: _________________________.
Fax: ______________

To: Originally Intended Purchaser
____,
______________,
______________,
____
Attention: ____________________
Fax: ______________

All the notices and other communications required or permitted under this Agreement that are addressed as provided in this Section 11.1 (*Notices*) will (a) if delivered personally or by courier, be deemed given upon delivery; (b) if delivered by fax transmission, be deemed given when electronically confirmed; and (c) if sent by registered mail, be deemed given three (3) days after the same has been sent. Any Party may from time to time change its address for the purpose of notices to that Party by giving a similar notice specifying a new address.

11.2 Entire Agreement
This Agreement supercedes all discussions and agreements (whether oral or written, including all correspondence) prior to the date of this Agreement among the Parties with respect to the subject matter of this Agreement.

11.3 Waiver
Any term or condition of this Agreement may be waived at any time by the Party that is entitled to the benefit thereof. No failure or delay on the part of the Assignee in exercising any power, right or remedy under this Agreement shall be construed as a waiver thereof, nor shall any single or partial exercise of any such power, right or remedy preclude any other or further exercise thereof or the exercise of any other power, right or remedy. Such waiver must be in writing and must be executed by an authorised officer of such Party. A waiver on one occasion will not be deemed to be a waiver of the same or either under breach or non-fulfilment on a future occasion. All remedies

and benefits, either under this Agreement, or by law or otherwise afforded, will be cumulative and not alternative and without prejudice to the other remedy or benefit, as the case may be.

11.4 Amendment

This Agreement may only be modified or amended in writing, duly executed by or on behalf of each of the Parties.

11.5 Severability

If any provision of this Agreement is held to be illegal, invalid, or unenforceable under Applicable Law, and if the rights or obligations under this Agreement of the Parties will not be materially and adversely affected thereby (a) such provision will be fully severable; (b) this Agreement will be construed and enforced as if such illegal, invalid, or unenforceable provision had never comprised a part hereof; and (c) the remaining provisions of the Agreement will remain in full force and effect and will not be affected by the illegal, invalid, or unenforceable provision or by its everance herefrom.

11.6 Governing Law

This Agreement shall be governed by and construed in accordance with the laws of India.

11.7 Arbitration

11.7.1 The Seller and Assignee hereby agree that they shall work together to resolve any disputes that may arise under this Agreement.

11.7.2 In the event that disputes do arise under this Agreement, which the Parties are unable to settle amicably, the dispute shall be settled by arbitration pursuant to the Arbitration and Conciliation Act, 1996.

11.7.3 The place of arbitration shall be Mumbai and the language of the arbitration shall be English.

11.7.4 The Parties shall jointly appoint a sole arbitrator. If the Parties do not agree on a sole arbitrator within thirty (30) days of the date of service of notice of arbitration by the Party initiating arbitration, the Parties shall each appoint one arbitrator.

The third arbitrator shall be the chairman of the arbitral tribunal and shall be appointed by the two arbitrators appointed by the Parties or, if they are unable to agree on the appointment of the third arbitrator, in accordance with the Arbitration and Conciliation Act, 1996.

11.8 Supremacy

In case there is any inconsistency between these presents and the other Transaction Documents, this Agreement shall prevail.

11.9 Payment

For the purpose of this Agreement, any payment shall be deemed to have been received by the Assignee the day on which the Collection and Payout Account is credited.

11.10 Mode of Payment

All monies, which the Assignee is entitled to receive under or in accordance with this Agreement, shall be paid by cheque, draft, or pay order drawn on a scheduled bank or by way of electronic funds transfer or mail transfer for crediting the Collection and Payout Account.

11.11 Performance

If by the terms of this Agreement, any act would be required to be performed on or within a period ending on a day, which is not a Business Day, then it shall be performed, on or by the immediately succeeding Business Day. Time is of the essence of the contract.

11.12 Acts to be performed by the Seller upon intimation

Upon request of the Assignee, the Seller shall, within a period of 15 days, do all such acts, deeds and things as may be required to further prefect the Assignee's right title and interest to the Loans and for such other matters as stated therein, breach of which shall entitle the Assignee to the remedies mentioned under Section 7 of this Agreement.

IN WITNESS WHEREOF the Parties hereto have executed this Agreement on the day, month and year first hereinabove appearing

Signed and delivered by
_________________, the within named
SELLER by its authorised representative
By: _________________
Name:
Title:

Signed and delivered by
____
________, the within named **Originally Intended Purchaser**, by its authorised representative
By:_________________
Name:
Title:

Signed and delivered by
____
________, the within named **ASSIGNEE**, acting in its capacity as trustee of __________ – __________ Trust by its authorised representative
By:_________________
Name:
Title:

SCHEDULE 1

Being the details of the Financing Documents

A. *Documents relating to the following financial assistances availed by_______________ from the Seller including:

1. Loan/working capital facility of Rs.___________:
Letters exchanged between the Seller and other lenders in relation to the ranking of security and sharing of proceeds there from; and
Forms filed/registered with Registrar of Companies in relation to, and all approvals obtained for, all the mortgage(s) / charge(s) referred to above.

2. Loan/working capital facility of Rs.___________:

* In case of multiple borrowers following schedule may be used:-

S.	Name of the Borrower	Principal Outstanding

No.		Amount (Rs. Lakhs)
1.		
2.		
3.		
4.		
5.		
	TOTAL	

B. Financing Documents relating to following financial assistances availed by ________________ from the Seller, including the following:

C. Financing Documents relating to following financial assistances availed by ________________ from the Seller, including the following:

D. Financing Documents relating to following financial assistances availed by ________________ from the Seller, including the following:

SCHEDULE 2

Being the list of movable/ immovable property referred to in the definition of Financing Documents

1. Movable/ Immovable properties securing the financial assistances from the Seller to ____________________:

2. Movable/ Immovable properties securing the financial assistances from the Seller to ____________________:

3. Movable/ Immovable properties securing the financial assistances from the Seller to ____________________:

4. Movable/ Immovable properties securing the financial assistances from the Seller to ____________________: