<u>**Securitisation in India: Next Steps**</u>[•]

Chairman Mr. Gopalakrishnan and friends,

I am happy to be here with you at the first of a series of seminars being organised by the Primary Dealers Association of India. In fact, this event is in fulfillment of one of the roles of the Primary Dealers Association, as a self-regulatory organisation, and as envisaged by us.

The number of PDs were just six when I inaugurated the Primary Dealers Association in March 1998 and the size of the family has more than doubled to thirteen in one year. Primary Dealers will have to play a significantly larger and more effective role in the Government Securities market this year. On our part, RBI will continue to offer full support to PDs in our effort to further develop the financial markets. In fact, the RBI has been facilitating the operation of PDs through a variety of measures and these are invariably discussed with them. The PDs have been in close coordination with the RBI on all matters of contemporary relevance in the Government Securities markets. We have been soliciting their advice on various matters and their advice has provided valuable inputs to us in fine-tuning some of the policies. Currently, the Primary Dealers Association is working closely with the Internal Debt Management Cell of the RBI in setting up the Electronic Dealing System. I believe that this will be in place by June 1999.

The Primary Dealers' presence in the Government Securities market has brought about an element of dynamism, both in the primary and secondary segments. Last year was a difficult year due to unprecedented international and domestic developments. With cooperation from PDs as well as other market participants, we were able to complete the large market borrowing program of Government smoothly.

In December 1998, I had spoken on the Development of Debt Markets in India and, this was followed up with another lecture on the development of money market in India. The major policy developments were reviewed and a detailed agenda for further action was drawn up. The Agenda which included technology, regulatory and legal issues and the need for standardisation of practices in debt markets, also underlined the imperative need to generate a strong retail segment of the gilt market. An internal sub-Group of the Technical Advisory Committee on Government Securities Market was set up to look into the various aspects of the repo market. The sub-Group has since submitted its report which is currently being examined by us. Meanwhile, in the Union Budget for 1999-2000, the Government has proposed to abolish stamp duty on transfer of debt instruments within the depository mode. This is expected to improve the volume in repo of PSU bonds and corporate securities. There is also progress in the proposal to amend

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[•] Inaugural address by Dr.Y.V.Reddy, Deputy Governor, RBI, at the Seminar on Government Securities Market, in Chennai, on April, 17, 1999. He is grateful to Dr.A.Prasad for his assistance.

Securities Contracts Regulation Act to enable improved regulation and functioning of debt markets. Guidelines for introduction of interest rate swaps are ready and we will be issuing them soon. I am mentioning these by way of illustration about implementation of the agenda laid out.

Similarly, there has been progress in regard to interest rates, on which I had spoken in June 1998 in Mumbai, while addressing FIMMDA, where some of you were present. I had narrated trends in both nominal and real interest rates in India and analysed the five important reasons for pressure on real interest rates in India. Six issues were flagged of which Government borrowing programme was the first. Market reforms relating to Government securities market and money market were also listed. In both these, PDs have a significant role to play.

My colleague, Mrs. Usha Thorat will speak in detail, on the Government Securities market, later today.

I would, therefore, speak on a sub-sect of the debt market, viz., securitised debt.

I will briefly explain for record, the concept of securitisation and highlight the importance of securitisation in terms of its benefits to the originator, investor and the financial system. The process of securitisation will then be dealt with, of-course, tracing the Indian experience in securitisation. The major legal and regulatory issues relevant are listed. Finally, to help operationalising what has been debated so far, I will place before you, what could be the next steps for development of this market.

Concept

Securitisation is a process through which illiquid assets are transferred into a more liquid form of assets and distributed to a broad range of investors through capital markets. The lending institution's assets are removed from its balance sheet and are instead funded by investors through a negotiable financial instrument. The security is backed by the expected cash flows from the assets.

Securitisation as a technique gained popularity in the US in the 1970. Favourable tax treatment, legislative enactments, establishment of Government-backed institutions that extend guarantees, and a pragmatic regulatory environment appear to have contributed to the successful development of this market. The market for securitisation in the US which is dominated by home mortgages has diversified to credit cards, home equity loans, student loans and small business loans.

UK is the second largest market for securitisation after the US. Areas of securitisation in the UK are broadly similar to the US and include residential mortgages, credit cards, consumer loans, commercial real estate and student loan. The Bank of England has played a leading role in evolving guidelines for banking and other authorised institutions in its loan transfers and securitisation. Now, the Financial Services Authority

(FSA) sets out the policy on securitisation and loan transfers. Experience of UK is of special relevance to India, and we should liberally draw on it.

Other countries in Europe have been relatively slow starters, though regulatory and legislative changes in Germany, France, Belgium and Spain have been fashioned to assist development of securitisation. In Japan, the securitisation market is not well developed since until recently, the Government had restricted securitisation to the assets of leasing, consumer loan and credit card companies. The Government has, however, amended laws to allow full-scale securitisaton as recently as in May 1997.

Features of Securitisation

Securitisation is designed to offer a number of advantages to the seller, investor and debt markets. For seller or originator, securitisation mainly results in receivables being replaced by cash thereby improving the liquidity position. It removes the assets from the balance sheet of the originator, thus liberating capital for other uses, and enabling restructuring of the balance sheet by reducing large exposures or sectoral concentration. It facilitates better asset liability management by reducing market risks resulting from interest rate mismatches. The process also enables the issuer to recycle assets more frequently and thereby improve earning. Finally, transparency may be improved since securitisation results in identifiable assets in the balance sheet.

For investor, securitisation essentially provides an avenue for relatively risk-free investment. The credit enhancement provides an opportunity to investors to acquire good quality assets and to diversify their portfolios.

It also provides opportunity for matching cash flows and managing ALM since a securitised instrument carries regular monthly cash flows and has varying maturities. The prevalence of secondary markets would offer liquidity.

From the point of view of the financial system as a whole, securitisation increases the number of debt instruments in the market, and provides additional liquidity in the market. It also facilitates unbundling, better allocation and management of project risks. It could widen the market by attracting new players on account of superior quality assets being available.

Now, a word of caution. Benefits are possible but there are views that the securitisation process, if not carried out prudentially, can leave risks with the originating bank without allocating capital to back them. While all banking activity entails operational and legal risks, these may be greater, the more complex the activity. It is felt that the main risk a bank may face in a securitisation scheme arises if a true sale has not been achieved and the selling bank is forced to recognise some or all of the losses if the assets subsequently cease to perform. Also, funding risks and constraints on liquidity may arise if assets designed to be securitised have been originated, but because of disturbances in the market, the securities cannot be placed. There is also a view that there is at least a potential conflict of interest if a bank originates, sells, services and underwrites the same issue of securities.

Process

For the uninitiated, let me briefly narrate the process. The process begins when the lender (or originator) segregates loans/lease/receivables into pools which are relatively homogenous in regard to types of credit, maturity and interest rate risk. The pools of assets are then transferred to a Special Purpose Vehicle (SPV) usually constituted as a trust. The originator may float the SPV as a subsidiary in the form of a limited company. Another option could be for the SPV to be floated jointly by the originator/individuals/banks/institutions who are interested in the securitisation deal. Based on these, the SPV issues asset backed securities in the form of debt, certificates of beneficial ownership and other instruments. The securities issued may be with or without recourse. Interest and principal payments on the loans, leases and receivables in the underlying pool of assets are collected by the servicer (who could also be the originator) and transmitted to the investors. Credit enhancement can add features to boost investor confidence. This could be in the form of a provision of recourse, a guarantee requiring the originator to cover losses, a letter of credit from a bank, or over collateralisation.

There could be three basic methods of transfer of assets, viz., novation, assignment and sub-participation. Novation is the clearest way of selling a loan and effectively transferring both the rights and obligations. In novation, the existing loan between originator and borrower is cancelled and a new agreement between the investor and borrower is substituted. The buyer steps into the shoes of the original lender or seller who ceases to have any obligations to the borrower. The loan, is therefore, excluded from the balance sheet of the seller.

An assignment transfers from the seller to buyer, all rights to principal and interest. Assignments for the purpose of disposing of assets may fall into two basic legal categories. The first is statutory assignment, transferring both legal and beneficial title. A statutory assignment will pass and transfer from the seller to the buyer all the legal rights to principal and interest. In most cases, it will also pass on all the legal remedies available against the borrower to ensure discharge of debt. In other words, the buyer acquires the full legal and beneficial interest in the loan. The second is equitable assignment, transferring only beneficial title. It does not transfer legal rights. Thus, a buyer may not be able to proceed directly against a borrower. The seller must be joined in action. However, the seller is not liable for debt.

Sub-participation does not transfer any of the seller’s rights, remedies or obligations against the borrower to the buyer. But, it is an entirely separate, back-to-back, non-recourse funding arrangement, under which the buyer places funds with the seller. In return, the seller passes on to the buyer, payments under the underlying loan, which the borrower makes to him. But, the loan itself is not transferred.

Securitisation in India

There is no authentic data on the magnitude of securitised debt in India. Available data indicates that ICICI had securitised assets to the tune of Rs.2,750 crore in its books as at end March 1999. Assets to the tune of Rs.1,200 crore is in the process of being bought over. CRISIL is reported to have rated about Rs. 1,200 crore of securitised transactions up to 1998. In addition, there have been several unrated transactions.

The first widely reported securitisation deal in India dates back to 1990 when Citibank securitised auto loans and placed a paper with GIC mutual fund. Since then, a variety of deals have been undertaken. Asset classes chosen have concentrated mostly on auto and hire purchase receivables of NBFCs. According to some estimates, 35 per cent of all securitisation deals between 1992 and 1998 related to hire purchase receivables of trucks and the rest towards other auto/transport segment receivables.

Apart from these, some innovative deals have also been struck. Earlier, in 1994-95, SBI Cap structured an innovative deal where a pool of future cash flows of high value customers of Rajasthan State Industrial and Development Corporation was securitised. An oil monetisation deal has been structured where the future flows of oil receivables accruing to a company was securitised. Real estate developers have securitised receivables arising out of installment sales. The recent securitisation deal of Larsen & Toubro has opened a new vista for financing power projects. The deal was a securitisation of lease receivables even before the plant was completed. Thus, this securitisation deal financed even the asset creation.

National Housing Bank (NHB) has made efforts to structure the pilot issue of mortgage backed securities (MBS) within the existing legal, fiscal and regulatory framework. Under the proposed transaction, mortgage debt shall be transferred/assigned/sold to NHB by Housing Finance Companies (HFC) (originator) pursuant to an agreement/contract in the ‘debt simplicitor form’. NHB will act as an issuer of pass through certificates (PTCs) and as a trustee on behalf of the investors. There is a view that there will be a conflict of interest if NHB, a regulator also acts as a trustee. However, as stated in the RBI discussion paper on universal banking, the ownership, regulatory and supervisory framework of the development financial institutions are under review.

On the basis of the Indian experience, the following features of securitisation appear noteworthy.

(a) Most deals have involved the transfer of beneficial interest on the asset and not the legal title.
(b) Most transactions have followed the pass-through mechanism.
(c) In fact, many transactions have followed the escrow mechanism where receivables are transferred to an escrow account for payment to the buyer.
(d) According to Duff & Phelps India, a rating agency, past deals have mostly been direct purchases of receivables by institutions and bigger NBFCs.
(e) Routing the transaction through a Special Purpose Vehicle is yet to gain popularity.

(f) There appears to be no secondary market for securitised debt.
(g) The market is unregulated and lacks transparency in terms of volume, price, parties to the transaction, etc.
(h) The settlement procedures are not clear.
(i) There are no standard accounting and valuation norms.

Legal and Regulatory Issues in Securitisation

A number of factors, mainly legal and regulatory, appear to have to be addressed to ensure healthy development of the Indian securitisation market.

The first relates to stamp duty. Under statutory assignment, securitisation involves transfer of mortgaged debt, which can be effected only by means of an instrument in writing. Every instrument by which property, whether movable or immovable is transferred attracts *ad valorem* stamp duty. Typically, the rate of stamp duty ranges from 0.5 per cent to as high as 4 to 8 per cent of the value of transaction. Thus, the process of securitisation becomes too expensive. Recently, there has been significant relief since stamp duty has been reduced to 0.1 per cent in some States. This is so, in Maharashtra in respect of transfer of movables; in Tamil Nadu in respect of transfer of housing loans/security created; and in Gujarat and Karnataka in respect of movables and immovables.

Second, under the Registration Act, 1908 transfer requires compulsory registration. This also imposes additional costs to the transaction.

Third, the Transfer of Property Act, according to some legal views, has held that assignment of a debt should be in whole and not a part assignment. Further, both the Transfer of Property Act and the Sale of Goods Act hold that only a property currently in existence is capable of being transferred. The laws impede development of securitisation in future receivables as transfer of future property does not fall under the definition of debt.

Fourth, some provisions of the Income Taxt Act, 1961 are reported to have an impact on securitisation. For instance, Section 60 of the Act, contemplates transfer of income without transfer of assets which are the source of the income. In such a case, the income so transferred is chargeable to income tax as the income of the transferor and is included in his total income. Similarly, there are other sections in the Act which inhibit the progress of securitisation.

Fifth, the existing set of foreclosure laws are said to increase the risks of mortgage backed securities by making it difficult to transfer property in cases of default. An efficient foreclosure law is undoubtedly the key to the success of secondary market operations.

Sixth, there is a view that a SPV structured as a company under the Companies Act may come under the definition of non-banking financial companies and hence is subject to prudential norms. I would like to clarify this issue here.

Special Purpose Vehicle as a Company

In the context of securitisation, if SPV is structured as a company under the provisions of the Companies Act, and engages itself in activities akin to investments, technically it becomes a non-bank finance company requiring registration under Section 45-IA of the Reserve Bank of India Act, 1934. However, in terms of the existing regulatory framework, only companies holding/accepting public deposits are subject to prudential norms and are also required to comply with SLR requirements as a percentage of their public deposits. Thus, SPVs, which are non-deposit taking NBFCs would not be subject to prudential norms prescribed by RBI on capital adequacy and credit exposure norms, although registration is mandatory.

Whether the Pass Through Certificates (PTCs) issued by the SPV would be considered as public deposits under RBI's NBFC Directions depends upon the class of subscribers to the instruments issued by the NBFCs. If the PTCs are issued to a category of subscribers, who are in the exempted category, then these Certificates are not be treated as public deposits. The exempted category of investors include Government, statutory authorities, companies including NBFCs, banks and financial institutions.

Another important aspect relates to whether NBFC directions apply if only the beneficial interest on the assets is transferred to SPV issuing the Certificates. As per RBI's regulations, the nature of assets for securing the deposits raised is not the criteria for the applicability of the Directions. However, the definition of public deposits does not include debentures/bonds, which are fully secured by the assets owned by the company in respect of which a charge has been created in favour of the trustees for such debenture/bond holders.

Next Steps

Legal Framework

Development of the market for securitisation in India will need efforts of the Central Government, State Governments, RBI and SEBI. I had briefly alluded to some of the legal and regulatory issues. The provisions of the Transfer of Property Act, Stamp Act, Registration Act and the Income Tax Act may have to be examined in detail in order to facilitate securitisation in a cost effective manner. Legislative amendment to various Acts is a time consuming process. Some of the issues, particularly the external legal environment affecting banks and financial institutions are receiving the attention of the Expert Group set up by the Government under the Chairmanship of Shri T.R. Andhyarujina. In the meantime, it may be useful to identify issues of a short-term nature which could be tackled on a priority basis. An in-house Group has been set up in the RBI to identify these issues and the action points and I want to make it clear that whatever I say here is without prejudice to the freedom of the Group to give its recommendations.

Regulatory Framework

Currently, there is no comprehensive regulatory framework for securitisation, understandably so, since it is of recent origin even in developed countries. SPV can be formed as a company under the Companies Act, 1956 or as a Trust under the Indian Trusts Act, 1882. Hence, SPV formed as a company will have to be registered as an NBFC under the RBI Act and is subject to RBI's regulatory framework. Secondly, such an NBFC will also come under the regulations of Companies Act. Thirdly, SPV formed as a Trust will come under the purview of the Indian Trusts Act. Fourthly, to the extent banks and financial institutions are involved in securitisation, they will continue to fall under RBI regulations. Fifthly, the Securities/Pass Through Certificates issued by SPV fall under the definition of securities under Securities Contract Regulation Act, 1956. There is thus a need to clarify and formalise a regulatory framework for securitisation.

Widening Investor Base

There is a case for widening the market for securitised debt. SEBI has recently permitted mutual funds to invest in these securities. A similar extension to FIIs to invest in securitised debt within existing ceilings could be examined. FIIs are already familiar with these instruments in other markets and can, therefore be expected to help in the development of this market.

Market Orientation

Regarding operational details in the market, it would appear to be advantageous to permit issue of these securities in dematerialised form only. These could also be notified as securities that would be eligible for repos. Technological upgradation will usher in a more transparent trading system and a more effective clearing and settlement mechanism will attract greater interest towards this instrument. This aspect could be addressed as part of clarifying the regulatory framework.

Role of RBI

So far, there has been no clearly or unambiguously well defined role for any agency in the development of a market for securitised debt. There has been a demand, particularly in the context of infrastructure financing, that the RBI should take the initiative for a number of reasons. Since SPV formed as a company will have to be registered as an NBFC under the RBI Act, it is possible to regulate them as a category of NBFCs. Banks and financial institutions are major players in securitisation, and in any case, they will be bound by RBI's guidelines in the matter. There is already a proposal to amend the Securities Contracts Regulation Act, to add an enabling provision to give powers to Government to provide formal jurisdiction to the RBI also in the regulation of the debt markets.

A possible approach for the role of RBI in the development of such a market involves setting forth comprehensive guidelines. The guidelines could :

a) indicate various legal sources and regulators that impinge on securitisation
b) outline the principles and objectives behind the approach to securitisation,
c) highlight the wider implications for the risks to banks and financial institutions resulting from securitisation,
d) set out the preconditions to securitisation structures
e) outline the rules applicable to transfer in order to limit the association between the originator and assets
f) set out considerations for credit enhancements
g) evolve specific guidelines on matters relating to disclosure requirements, valuation procedures, accounting standards and eligibility norms.

To conclude, I would leave these thoughts with you at this stage. I invite suggestions from Primary Dealers and other market participants on a possible approach to developing a market for securitised debt in India.

I wish the Seminar all success. I am confident that the seminar will not only disseminate information but also come up with suggestions.