Chapter 8 Role of Regulators & other Agencies

8.1 Role of Regulators

8.1.1 Securitisation essentially involves moving the assets from the balance sheet of the Originator to an SPV. The SPV then proceeds to issue securities in which various entities invest their funds. At each stage regulators have a crucial role to play, to ensure that the objectives of securitisation are achieved with the larger interests of the financial system always held uppermost. The role of the regulators emerges, vis-à-vis their regulatory interest in the various facets of the transaction. Since securitisation lends itself primarily to financial assets, more often than not, the Originator would be a FI in which case, the Central Bank of the country would have valid concerns relating to the transaction. These may be related to determination of whether the assets have actually moved off the balance sheet or calculation of any residual risks that may remain with the Originator. An additional aspect may be regarding the health of the Originator's balance sheet subsequent to the cherry picking that normally goes along with securitisation. The regulators would also be concerned with treatment to be accorded to any credit enhancement or other ancillary facilities provided by the FIs to securitisation transactions either of their own assets or to outside transactions. RBI being the Regulator of the major components of the Indian financial system, viz., banks, development financial institutions and NBFCs has a special role to ensure that the financial intermediaries prudently engage themselves in securitisation activities. This is more so because despite the fact that clear benefits accrue to the organisations that engage in securitisation, these activities have the potential to increase the overall risk profile if they are not carried out prudently. For the most part, the types of risks that financial institutions encounter in the securitisation process are identical to those that they face in traditional lending transactions including credit risk, concentration risk, interest rate risk, operational risk, liquidity risk, rural recourse risk and funding risk. However, since the securitisation process separates the traditional lending function into several limited roles such as originator, servicer, credit enhancer, trustee, investor, the type of risks that our institutions will encounter will differ depending on the roles they assume. There is, therefore, a need for the RBI to design an appropriate regulatory framework / prudential guidelines to ensure that these institutions participate in the process of securitisation more prudently and derive the benefits it offers more objectively.

8.1.2 Another major category would be the securities regulator like SEBI and the Stock Exchanges who normally stipulate the disclosure norms about listed and tradable securities. At times, these institutions also lay down norms restricting the type of securities or the class of investors to which they can be issued. Similarly, there would be regulatory issues related to incorporation of the SPV, its capitalisation, tax treatment etc. Accounting standards and tax rulings related to treatment of the upfronted profit in the books of the Originator or the income accruing to the SPV on behalf of the investors in the securitisation issues will also come into play. Thus, Institute of Chartered Accountants of India as well as the tax authorities would have to put into place a system of clear and unambiguous rules, which would serve as guidance for various situations.

8.1.3 Regulation thus would be impacting specified activities as well as the entities that perform these specific activities. This section (Para 8.1) looks at the regulatory aspects on various activities that are involved in a securitisation transaction. Also covered are the areas of regulation required over the entities involved, such as, the Originator, the SPV and Investor balance sheet etc.

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.

Accounting and Taxation Treatment

Keeping gearing low does have a significant bearing on the risk perception that lenders/ investors have about a corporate. Securitisation in its true form achieves an off-balance sheet effect, and hence has a positive impact on the debt-equity ratio of the Originator. There is thus a requirement for clear standing definitions for a True Sale, which if adhered to would qualify the transaction as an off-balance sheet funding. Since accounting norms / standards are laid down by the Institute of Chartered Accountants of India (ICAI), they would be required to come out with an accounting standard/ guidance note on accounting for securitisation. Clarity would also need to emerge on the tax treatment that would be accorded to the assets moving off the balance sheet or the income being up-fronted. In many cases, it will so happen that the True Sale criteria for one purpose may be different from the criteria for any of the other purposes. Availability of a clear and reliable set of criteria for each purpose would serve as a source of tremendous comfort to both issuers and regulators.

The recommendations of the WG on Accounting treatment are given in Annexure – II. The taxation issues are detailed in Chapter 9.

8.1.4 Issuance related Regulation

The activity of issuance of securitised paper would bring into play the role of regulators such as SEBI and Stock Exchanges. These bodies stipulate the information that must be disclosed publicly about listed securities. In some cases, they may also dictate investor classes to which a particular type of security may or may not be sold. An added area of regulation may be on the nature of entities, whose assets can be securitised or the asset classes, which can be securitised.

8.1.5 Disclosure Norms

The nature of securitised paper being considerably different from traditional securities, the nature of disclosure norms on its issuance would also differ. Most of these disclosures are fundamentally different from what is required for normal issues of equity and debt. As the regulator of the capital market, SEBI may have to examine and come out with detailed disclosure norms for issuance of securitised paper, by way of a public issue. In case of private placement also some best practice norms may need to be put in place as detailed in the Annexure - III on Disclosure Norms. These norms would cover the issuance of such

securities as well as ongoing disclosure requirements over the life of the instruments. Some of the areas on which disclosure would be required are:

- the characteristics of the underlying assets (factual information about the selected pool on various parameters, representations on past performance, etc.)
- agreed procedure for administration / servicing
- nature and extent of credit enhancement, other ancillary services
- broad purpose and contents of legal documents involved
- legal and financial disclosures on the Originator and SPV, disclaimer of their liability except to the extent explicitly specified
- nature and structure of instrument

The WG discussed in detail various disclosures required and have prepared a background paper enclosed as Annexure - III.

8.1.6 Listing Requirements

Stock Exchanges ordinarily lay down the listing requirements for various securities. They would necessarily have a role to play in this regard. The structures of securitised paper would need to keep in mind various parameters, some of these could be:

- Names of exchanges, which permit listing of securitised paper, e.g. only NSE permits listing of securitised debt at the moment in India.
- Minimum issue size.
- Availability of listing in Demat mode and consequent stamp duty concessions. Steps are already being taken by the Ministry of Finance to extend the benefits of demat trading, presently available only to equity, also to debt securities. A point of concern here would be the possible omission of securitised paper in the proposed notification, which would permit dematerialised listing and trading in Debt Securities.

8.1.7 Regulation of the SPV

The SPV may be incorporated in any one of the many legal forms possible. The structure adopted may be that of a Firm, a Company, a Trust or a Mutual Fund etc. Consequently, the provisions of the parent law for incorporation of such entity, i.e. the Partnership Act, the Company Law or Trust Act would need to be adhered to while setting up the entity. In addition, when the SPV is set up as a Mutual Fund Trust, specialised regulators like the SEBI would also come into the picture. These issues, as also the possibility of the SPV falling into the NBFC categorisation have been discussed in detail in Chapter 7. It would, however, be pertinent to maintain here that the RBI being the regulator would need to lay down criteria which would determine that the SPV should remain exempt from NBFC guidelines.

There would be another two aspects of the activity of the SPV, which would attract regulation. These would be the tax treatment and the accounting treatment to be accorded to the transaction being routed through its books. The tax authorities of the country would therefore, need to put into place a clear set of taxation rules which would avoid or prevent double taxation merely because an activity is being routed through an SPV. Similarly, the accounting standards would need to be developed regarding the format of the SPV balance sheet, treatment of the upfronted profit, liability display regarding future performance obligations against securitised assets etc.

8.1.8 Investment related areas

For securitisation to take off in big way, investor acceptability would be of paramount of importance. The investor for securitised instruments, to begin with, is likely to remain confined to the private placement market amongst institutions. The investment policies of most institutional investors are influenced by the prescriptions relating to asset-liability management, prudential exposure and risk weights for various categories of instruments that they may invest in. Specific quantitative limits in each area would have to be laid down in this regard by the concerned regulators for individual institutions The quantitative limits/risk weights etc, considered appropriate in each case are enumerated in detail elsewhere in the report (Annexure IV). The various institutional investors and their regulators who would need to put into place specific guidelines in this regard are listed below.

Investor		Regulator
Commercial banks, Co-operative banks, RRBs	-	RBI
Public Financial Institutions	-	RBI, MOF
Non-banking finance companies	-	RBI, DNBS
Mutual funds	-	SEBI
Insurance companies	-	MOF / IRA
Provident funds	-	MOF / PF Commissioner
Others	-	MOF / Appropriate Authority
Primary Dealers	-	RBI, IDMC

Illustrative Prudential Guidelines are enclosed as Annexure – IV.

8.2 Role of Other Agencies

8.2.1 Administrator / Servicer

8.2.1.1 The task of the administrator is to collect the receivables, take appropriate enforcement action when necessary to pursue their payment and to pass them over to the SPV. The Originator's familiarity with the assets and the Obligors makes it the obvious party to administer them. In many cases, to keep the collection efficiency uniform, the staff of the Originator who are involved with administration do not know which assets out of the total portfolio have been securitised and which remain with the Originator. Although most transactions provide for an option to change the administrator, it could prove impractical to effect this, especially where retail loans have been securitised. There is urgent need to segregate the assets with the administrator from other assets of Originator.

8.2.1.2 As the market for securitisation matures, it is expected that specialised entities that would provide administration services for a fee would emerge. Even today, entities providing factoring services could take up the task of administration provided they have the necessary infrastructure and skills.

Credit Enhancers

8.2.2 Guarantor / Insurer

8.2.2.1 Credit enhancement as an integral part of any securitisation transaction, plays an important role in investor acceptability and widening of the securitisation market. Although credit enhancements internal to the transaction structure play an important role, their impact could be limited. (Internal credit enhancements frequently resorted to are cherry-picking of the asset pool to be securitised, over-collateralisation, provision of cash collateral by the Originator, etc).

8.2.2.2 When the intrinsic credit quality of the Originator is not very high, it becomes essential to obtain some sort of external credit enhancement in the form of a guarantee / insurance from a third party. External credit enhancements can usually take form of:

- Letter of Credit / Guarantee

- Monoline Insurance
- Multiline Insurance

Each technique can provide full or partial support depending upon the credit quality of the portfolio. In general, the quantum of credit enhancement would vary inversely with the inherent credit quality of the portfolio.

Letter of Credit / Guarantee may be provided by a commercial bank / financial institution for a specified nominal amount or as a full cover of the SPV's obligations. Such enhancements serve the intended purpose only if supplied by a Triple ‘A’ rated bank.

Monoline Insurance Companies are engaged in the single line of business of writing financial guarantees. These are mostly US-based companies who in the last decade have entered OECD countries and more recently are entering EMs. Their most common function is as 100 percent guarantor of transactions' principal and interest payments. They all hold Triple 'A' insurance claims paying ability ratings.

Multiline Insurance Companies are general insurance companies who are in the larger business of insurance and provide risk cover to specific aspects of securitisation transactions also. Those normally provide risk cover upto a percentage of portfolio value.

While a structurer may chose any one of credit enhancement techniques, it is essentially ensured that the fee paid for the credit enhancement is offset by the economic benefit of better rating and consequent price advantage made available to the Originator.

In the **Indian context**, LIC and GIC (including subsidiaries) being the only insurers, pending entry of the private sector, need to be encouraged to provide pool insurance to asset-backed structures and play the role of multiline insurers. FIs could also be encouraged to engage in the activity either on the strength of their existing balance sheets or through independently managed subsidiaries floated specifically for monoline insurance. The subsidiary route could be the preferred option because the parent-bank / FI may be an active investor in the market for securitised paper or may have other exposures to the Originator and would in either case face a conflict of interest.

8.2.3 Liquidity Support

Apart from the credit quality of the asset pool, investors in securitised paper also need to be shielded against delays in repayment. Investors look to liquidity support providers to bridge time lags between collections from the Obligors and servicing of investors. Liquidity support covers the following:

Reserve account: A certain amount is set aside in a reserve account to provide liquidity in the event of delay in collections from the underlying assets. Once the collections are received they are used to top up the reserve account to the extent to which it was previously drawn.

Revolving line of credit: The Originator arranges for a bank to provide a revolving line of credit for a specified limit. Delays in collections are bridged by drawing upon this line of credit, which is repaid on receipt of collections.

Lien: A lien marked on any collection account of the Originator (other than the account pertaining to collections from the securitised assets) can also be a source of liquidity support. The mechanism of using funds and topping up the account on realising collections is similar to the other forms of liquidity support.

8.2.4 Interest rate and forex risk cover provider

Investors in securitised paper may want to hedge the risk related to adverse changes in the interest rate. Where cross-border issuance of securitised paper is involved, forex risk cover

may be sought by investors either in cases where the transaction inherently involves cross-border flow of funds (for example, export securitisation), or in case of domestic securitisation transactions in which foreign investors put their money. The need to hedge against adverse interest rate and currency movements is not unique to securitisation and these services can be provided by the same agencies that otherwise provide them.

8.2.5 Fiduciary Services Provider

The nature of securitised paper makes the role of a trustee / investors' representative vital. The trustee's role in a securitisation transaction is more active than that of debenture trustees in the sense that the Fiduciary Services Provider performs various tasks such as operations & systems review / due diligence in partnership with the Seller/Servicer of the loans/assets. The scope of the review contemplates all operations & systems affecting the running of the transaction typically Origination, Collections, Delinquency and Default Management, Data Management & Systems Operations. The Fiduciary Services Provider also assists the Seller/Servicer in resolution of any servicing related issues and preparation of the 'Servicer Report'. Other transaction administration functions include periodic 'waterfall' calculations, periodic 'trigger' monitoring and liasing with the Seller/Servicer and other agencies for transaction data.

Others

8.2.6 Structurer

The structurer is involved in an advisory role throughout the transaction. Its involvement spreads across the entire gamut of sub-processes in securitisation covering pool selection, decisions regarding credit enhancement and other ancillary services, structuring the instrument and payment mechanism, documentation, systems analysis and development, forecasting investor acceptability, etc. Internationally, this role is played by investment bankers and a similar trend is already visible in India.

8.2.7 Rating Agency

Like any other capital market debt security, securitised paper also needs to be rated by recognised rating agencies. In India, the existing rating agencies have already acquired a fair degree of expertise through rating of structured obligations and other issues that are quite similar to securitisation. The circumstances under which the assignment of assets to the SPV may become vulnerable to the insolvency of the originator are, inter-alia, a) the transaction is not done at fair market value: b) the risks and rewards in the assets are not transferred to the SPV; c) the security is not properly perfected under the relevant law. The rating agencies could be enjoined upon to gear up to evaluate such risks.

8.2.8 Market Maker

The presence of market makers for securitised instruments will give a boost to the speedy integration of securitisation with the capital markets. At the moment there are no such agencies in the Indian market. Over a period of time it may become necessary for NHB to assume a market making and underwriting role for mortgaged backed securities, similar to the one being played by Fannie Mae in the US. Infrastructure Development & Finance Company and such could also be encouraged in this regard.