

Chapter 9 Legal & Taxation Recommendations

9.1 Amendments required to various statutes to facilitate securitisation

The essence of securitisation lies in the legal, regulatory, tax and accounting treatment of sale of the assets. However, widespread and specific amendments are required to various laws, both at Central and at State levels. Various legislations require many issues to be addressed to ensure that securitisation can be carried on without any legal and procedural hassles.

In the absence of the amendments suggested below, the process of securitisation would be very tedious as experienced by players in the market. The positive endorsement provided by the Government of Maharashtra notifying reduction of stamp duty to 0.1 per cent coupled with SEBI leadership in equating securitised paper with other debt instruments for investment by MFs have encouraged simple structures. The amendments suggested will simplify the process and give a push to securitisation thus bringing in the desired efficiencies at a faster rate.

Briefly, some of the Legislations / Enactments involved and their impact on securitisation transactions are as follow.

9.1.1 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.

9.1.2 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.

9.1.3 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.

9.1.4 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).

9.1.5 SEBI (Mutual Funds) Regulations, 1996.

The provisions of SEBI (Mutual Funds) Regulations, 1996 would require amendment in regard of investment objectives permitting MFs to invest in MBS.

9.1.6 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.

9.1.7 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.

Amendment Required in Central Laws

9.2 Transfer of Property Act, 1882

Defining 'Securitisation':

'Securitisation' does not per se enjoy any legal definition in the country. It is suggested that whilst amendments would be made across laws, a common definition of securitisation precede such amendments to lend uniformity of approach. It would further avoid any person from terming any type of transaction as a securitisation transaction to avail of the benefits provided by the law for securitisation transactions.

Recommended Insertion of following definitions in Section 3 in the Transfer of Property Act, 1882:

'Securitisation' shall mean

- a) the transfer by sale or assignment of the whole or part of the assets including actionable claims by any entity which owns or has the rights, title and interests in the assets to a special purpose vehicle (SPV); and
- b) issuance of securitised debt receipts or securities, equity or certificates entitling holder thereof to the receipts of monies on account of the assets (including by virtue of any credit enhancement or liquidity facilities obtained by the SPV or specified person) by assignee under clause a) above.

Easier assignment for mortgage backed receivables:

Sec 130 provides for transfer of claims to unsecured debts in the nature of actionable claims, which are transferable on execution of an instrument of transfer. Since there is no security involved, the rights to such claims pass absolutely, immediately on execution of the instrument of transfer.

Sec 8 provides that “unless a different intention is expressed or necessarily implied, a transfer of property passes forthwith to the transferee all the interest which the transferor is then capable of passing in the property and in the legal incidents thereof”. In case the property in question is a claim to a debt or other actionable claim, the securities therefore also stand transferred along with the claim to the debt.

In the circumstances the following two possibilities emerge:

- a) That all claims to debts being securitised are transferred without the underlying security, i.e., as actionable claims. This would however have the related problem of investor acceptance for totally unsecured instruments and also problems related to bankruptcy of the Originator.
- b) That special exemptions be provided for transfer of mortgage backed or other secured debt.

The ability to transfer a claim for a mortgage backed debt or claim for other types of secured debt can be achieved by incorporating a proviso to the definition of actionable claim in Section 3 of the Transfer of Property Act, 1882.

Recommended proviso to definition of actionable claim :

“Provided that in case of Securitisation, Actionable Claim shall mean and include a claim to a debt or any part thereof including debt secured by mortgage of, or charge on the immovable property or by charge, hypothecation or pledge of moveable property or beneficial interest in moveable property or receivables whether such claim or interest is existent, accruing, conditional or contingent.”

Transfer of Future Receivables/Future Debt

Easier and automatic assignment of future receivables

Whilst Section 3 of the Transfer of Property Act, 1882 defines an actionable claim to also include an accruing, conditional or contingent debt, there is lack of clarity relating to transfer of such and other types of future debt.

Section 5 of the Transfer of Property Act, 1882 lays down that whilst transfer may take place at present or in future, the property that is the subject matter of transfer must be in existence in present. A transfer of property that is not in existence operates as a contract to be performed in future or in other words as an executory contract. The implication of this provision is that in case of bankruptcy of the Originator, the contract can be treated by the Liquidator as being an executory contract, which can be therefore terminated by him. The

monies that are paid as consideration by the investors for the purchase of the receivables, while recoverable would be as unsecured creditors of the Originator.

This is a significant impediment in perfecting security interest in future receivables and closes off the option of achieving status similar to transactions in a variety of asset classes which are well developed internationally, e.g., securitisation of future trade receivables from sale of commodity products. Companies in developing markets (particularly Latin America) have raised cross border finance at extremely attractive rates by piercing the sovereign ceiling leveraged by sale of future receivables.

As is clear from the provisions dealing with Actionable claim, *a claim to a debt, whether existent, accruing, contingent or conditional* (the latter two types being future debt), are capable of being transferred in present. It is recommended that this position be clarified by virtue of an amendment to the Transfer of Property Act.

Insertion of the following proviso to Section 5 of the Transfer of Property Act, 1882 would create an enabling provision for transfer of such future debts.

“Provided that for the purposes of securitisation, an actionable claim accruing in future or conditional or contingent upon any event shall be deemed to be a property capable of being transferred in present.”

Extension of permissions or approvals

Another important aspect that requires being addressed is whether the permissions obtained from Governmental authorities, statutory bodies and no-objection certificates from various parties entitled to issue such, are made available to the Investor.

Securitisation requires that the SPV be allowed to act in such manner as to enable it to recover the dues to the investors. Such action might include assignment of statutory rights such as Telecom Licenses to a third party. On such action by the SPV, the parties to the transaction change – however, no additional liability or rights are created by virtue of the transfer or assignment protecting the term lenders’ interests. In case of securitisation and assignment of the receivables thereto, absence of the permissions and consent, whether required under any statute or contract, can have a chilling effect on success of such transactions.

Having regard that the securitisation market should be popularised and to create a conducive environment for securitisation as a financing alternative, it is suggested that the NOCs/permissions granted/given by statutory bodies, Government authorities or private contracting parties to the Originator be available to the Investor as well.

Recommended to insert a new section 130B in the Transfer of Property Act as follows:

“130B. Any permission or approval obtained for creation of mortgage, charge, hypothecation or pledge to secure any actionable claim, transferred by way of and for the purpose of securitisation, shall continue to be valid for all further transfers.”

Foreclosure Procedures

Absence of speedy foreclosure procedures on mortgages has often been cited as the prime deterrent to the development of securitisation as a product in India. The Transfer of Property Act deals with the provisions relating to the creation of various kinds of mortgages under the Indian law. However, the law is silent in two vital areas, viz.

- (a) the procedure for transfer of mortgages from the principal lender to any other entity (whether the securitisation SPV or otherwise),

- (b) the procedure for speedy foreclosure and recovery against the mortgage without the cumbersome and time-consuming process involving the intervention of the Courts.

The need to protect individual homeowners from harsh repossession and eviction procedures that could be employed by powerful lenders, in the absence of protective mechanisms in the property laws, can, hardly be overemphasised. Nevertheless, recognising the potential of securitisation as an instrument in the Housing Finance Industry, many countries have enacted special legislations or have at least inserted specific provisions in their property laws that permit speedy foreclosure in respect of securitised loans. These provisions provide a right to automatically foreclose on the mortgage by a special summary procedure. Most such legislations do however require that the debtor (homeowner) should have specifically agreed to application of such summary procedures to his mortgage. In the event of his desiring to avail of a mortgage financing which is not subject to securitisation and speedy foreclosure that goes along with it, the loan may attract a higher interest rate or differing terms. This is so because by not being securitisable, the economics of such loans would be vastly different from securitisable loans.

In India, NHB, is already in the process of assuming the role being played by Fannie Mae as regards mortgage securitisation in the USA. Towards this end, NHB have already initiated the process of amendment of the NHB Act which would give them the necessary powers for foreclosure on mortgages securitised through them.

Since over a period of time, other market intermediaries like NHB are going to emerge in the MBS market, it is recommended that after Section 67 A of the Transfer of Property Act, a new section 67 B be inserted as follows :

‘Section 67 B

- I. Notwithstanding anything contained in Section 67, in the case of a mortgaged asset, the securitisation SPV shall have the right of sale of the mortgaged property without the intervention of the court or obtaining a decree from the Court in this regard in case the following are satisfied :
 - a) there is a delay of 60 days in the payment of principal or interest, and
 - b) the mortgagor is notified of the default by the SPV or its representative, giving the mortgagor further 30 days period to make the payment of principal or interest due in full, and
 - c) the mortgagor fails to make such payment within the said period of additional 30 days also.

Provided that the mortgagor while mortgaging the property and securing of the debt had specifically agreed to application of the summary procedures as defined above to his mortgage debt.’

9.3 Code of Civil Procedure, 1908

Resolving the issue of part assignment:

The Transfer of Property Act recognises a claim to a debt to be an independent actionable claim. Therefore, it should technically be possible to assign a part of claim to a debt pursuant to securitisation. However, courts in India while interpreting Order II Rule 2 of the Code of Civil Procedure have held that it is not advisable for a debtor to face multiple suits/litigation

on a single debt as originally contracted by him. The Court Rulings have, in effect, created a situation that claim to a debt cannot be assigned in part.

Order II rule 2 is required to be amended as the interpretation of the Rule in its present form prevents maintainability of suit in case of part assignment of claim to a debt and thus calls for continued involvement of the Assignor even after securitisation.

It would normally be expected that the Originator (in its capacity as Administrator) would file the suit on behalf of the SPV also for the SPV's portion of the claim to a debt rendering this amendment unnecessary. However, it may be advisable to give the two parties distinct causes of action, to cover the following possibilities:

- a) dispute between the SPV and the Originator (the SPV normally reserves the right to change the Administrator), and
- b) bankruptcy of the Originator (the SPV may be required to file a joint suit with the other creditors of the Originator)

Recommended to insert a proviso to the Explanation to Order II, Rule 2 Code of Civil Procedure, 1908 as follows to enable maintainability of suits by assignor and assignee(s) as separate and distinct causes of actions.

“Provided that in the event of Securitisation, the claims of the [transferor] and the [transferee] shall be deemed to be claims in respect of distinct causes of action.”

9.4 Companies Act, 1956

The Companies (Central Government) General Rules And Forms, 1956 framed under the Companies Act, 1956

In case of transfer of claim to a debt with the underlying security, whether in the form of hypothecation or pledge of movables or mortgage of immovable property, the name and description of the chargee would, in terms of the instrument of transfer, be altered. Under Companies (General Forms and Regulations), 1956, this would necessitate filing of Forms 8 & 13 under Section 135 of the Companies Act, 1956, for effecting modification of charge. This is due to the circulars issued by the Department of Companies Affairs, despite absence of any provision requiring registration of such modification in the Companies Act, 1956.

To avoid multiplicity of filing forms with the Registrar of Companies in case of transfer of charges pursuant to securitisation, it is

Recommended that the Central Government designate the Department of Company Affairs (or a single Registrar of Companies) as the sole repository of any alteration being required to the Register of Charges on account of securitisation.

It may also be stipulated that the requirement of Company having to co-sign the form is not mandatory provided that the copies of previously filed Forms 8 and 13 filed by the Originator and the Company are submitted alongwith the form for modification of charge.

9.5 SEBI (Mutual Fund) Regulations, 1996

The following clarifications and amendments may be necessary to the SEBI (Mutual Funds) Regulations, 1996.

Removal Of Prohibition on Investments In MBS (as a class of securitised debt) by Mutual Fund Schemes

The MF regulations stipulate the securities in which a MF can invest its funds. Currently, this includes only transferable securities in the capital market or the money market, and privately placed debentures or securitised debt.

The 2nd proviso to Regulation 43 of the SEBI (Mutual Fund) Regulations, 1996, states that in case of securitised debt, such fund may invest in asset backed securities excluding MBSs.

Permitting MFs to invest in MBSs would be desirable, as this would expand the investor universe for these securities. While restriction on MFs investing in MBSs may have been justified at the relevant time, at present continuing the distinction would deprive sectors like infrastructure projects/housing finance etc. the benefits of investment by MFs in securitised paper who comprise a major chunk of the investor community in structured obligations. It may be worthwhile to mention that the NHB itself is shortly bringing out its pilot issue of MBSs of Housing Finance Companies. In that context, it is reasonable to presume that the market conditions have altered and matured sufficiently to permit investment by MFs in MBSs.

It is recommended that the 2nd proviso to Regulation 43 of SEBI (Mutual Fund) Regulation, 1996 be deleted.

AMENDMENTS TO STATE LAWS (LEGISLATION-WISE DESCRIPTION OF CHANGES REQUIRED)

9.6 Rationalisation of the stamp duty structure and registration charges

Every instrument by which property, whether moveable or immovable, is transferred, attracts ad valorem stamp duty under Article 23 of Schedule I of the Indian Stamp Act, 1899 (and under the respective State stamp legislations).

Individual states have their own State Stamp legislations which vary based on the class of asset being transferred and govern the rates of duty applicable on any transaction. Typically, the lowest rate of duty is in the case of transfer of shares which is normally at 0.5%. The higher rates can amount to as much as 4% to 10% of the value of the transaction.

Stamp duty is applicable on the transfer/sale of receivables involved in securitisation. However, the prevailing prohibitive stamp duty structure acts as an impediment to the development of securitisation. The states of Maharashtra (limited to transfer of movables), Tamil Nadu (limited to transfer of housing loans/security created thereunder) and Gujarat & Karnataka (transfer of movables & immovables) have reduced the stamp duty payable on assignments/conveyance in securitisation transactions to 0.1%. Recently, the state of West Bengal too has reduced on the stamp duty on securitisation transactions to 0.1%.

This initiative should ideally be effected uniformly across all states for transfer of unsecured debt, debt secured by movables and debt secured by immovable property.

It is submitted that the Parliament with a view to encouraging securitisation prescribe the maximum rates of stamp duty that can be levied by the States and further prescribe a cap on the monetary value on levy of such duty.

9.6.1 The texts of the notifications issued by the States of Maharashtra, Karnataka, Tamilnadu and Gujarat in exercise in their statutory power in this regard are as follows:

- (i) Karnataka Stamp Act, 1957.

“Order dated 30th April, 1997

No. RD 184 MUNOMU 97(P). In exercise of the powers conferred by clause (a) of Sub-Section (1) of Section 9 of the Karnataka Stamp Act, 1957 (Karnataka Act 34 of

1957), the Government of Karnataka, being of the opinion that it is necessary in the public interest so to do, hereby reduces with effect from 1st April, 1997, the duty with which the instrument of securitisation of loans or of Assignment of debt with underlying Securities is chargeable under Clause (1) of Article 20 of the Schedule to “Fifty Paise” for every Rs 500/- or part thereof the loan securitised or debt assigned with underlying securities.”

The Government of Karnataka, Department of Stamps & Registration have specified that that with effect from 1st April 1999,

“Deeds relating to assignment of receivables in the process of securitisation will be charged to a reduced duty of 0.1% subject to a maximum of Rs. One Lakh.”

(ii) Bombay Stamp Act, 1958

“Order dated 11th May 1994

No. STP. 1094/CR-369/(C)-M-1 – In exercise of the powers conferred by Clause (a) of Section 9 of the Bombay Stamp Act, 1958 (Bom.LX of 1958), the Government of Maharashtra hereby reduces with effect from 1st April 1994 the duty with which an instrument of securitisation of Loans or Assignment of Debt with underlying securities is chargeable under Clause (a) of Article 25 of Schedule 1 to the said Act, to “Fifty Paise” for every rupees 500 or part thereof of the loan securitised or debt assigned with underlying securities and in case of instrument of Assignment of Receivables in respect of use of credit cards to “Two Rupees and Fifty Paise for every rupees 500 or part thereof.”

(iii) Bombay Stamps Act, 1958 (as applicable to the state of Gujarat)

“Order dated 25th February 1998

No. GHM – 98-221H.STP/1096/2527/H.1. In exercise of the powers conferred by Clause (a) of Section 9 of the Bombay Stamp Act. 1958 (Bom LX of 1958), the Government of Gujarat hereby reduces the duty with which an instrument of securitisation of Loans or the Assignment of Debt with underlying securities is chargeable under Article 20(a) of Schedule 1 to the said Act, to ten paise for every rupees 100 or part thereof of the loan securitised or debt assigned with underlying securities.”

(iv) Indian Stamp Act, 1899

“Notification Dated 17/2/1997

In exercise of the powers conferred by clause (a) of sub-section (1) of section 9 of the Indian Stamp Act, 1899 (Central Act II of 1899), the Governor of Tamil Nadu hereby reduces the duty chargeable under the said Act to 0.1% in respect of any instrument of securitisation of housing loans executed by housing finance institutions in favour of refinancing or intermediary investment institutions evidencing assignment of debt, whether with or without the security of mortgage of immovable property, pledge or hypothecation, including any instrument issued by the assignee or his agent which

purports to evidence and/or transfer any interest in the debt and/or any underlying security therefor and/or any transfer or transfers thereof.”

It will be pertinent to reproduce the order of the Government of Tamil Nadu explaining the rationale behind the notification dated 17.2.1997.

“G.O.Ms. No. 58 dated 17.2.1997

ORDER: The Government have examined the suggestion of Government of India for reduction or remission of stamp duty on instruments of securitisation of housing loans by Housing Finance Institutions like Housing Development Finance Corporation etc. with a view to implement the objective of the National Housing Policy to increase the liquidity of the housing finance system by establishing a viable secondary market. As per the present provisions of the Indian Stamp Act, 1899, an instrument of securitisation of housing loans executed by Housing Finance Institutions in favour of refinancing or intermediary investment institution is chargeable to duty as a deed of conveyance at 13% of the loan value in the State of Tamil Nadu.

The Government considers that the levy of 13% stamp duty on such instruments of securitisation will render the whole process unviable. It is felt that unless the stamp duty on such instruments is at a token level, instruments of securitisation cannot be traded in secondary capital market, particularly for housing, would not be possible. It is observed that the Government of Maharashtra had issued a notification specifying that the stamp duty payable on instruments of securitisation transactions would be 0.1%.

Taking into consideration of the above, the Government have decided to reduce the stamp duty payable under the Indian Stamp Act, 1899 in respect of instruments of securitisation of housing loans by Housing Finance Institutions to 0.1% of the securitisation value

9.6.2 Recommendation regarding rationalisation of Stamp Duty structures

It is recommended that a uniform stamp duty of 0.1% be levied in all states on all instruments of transfer/sale and assignment of debt (whether unsecured, or secured by movables or by immovable property) for the purpose of securitisation and a monetary cap of Rs two lakh be placed on such stamp duty.

Recommended Draft of provisions that should be inserted in the Indian Stamp Act, and under the respective State Stamp Legislations or amendments that may be made by notifications under the legislative framework

The following amendments/notification under the respective stamp legislations are aimed to cover the following aspects in any securitisation transactions:

- instrument of assignment of debt for the purposes of securitisation;
- issue of PTCs/participation certificates, units, etc. constituting an interest of the holder thereof in the securitised debt, and the transferability of such instruments between the investors inter se.

(a) Insertion of the following definition of 'Securitisation Deed' as Section 2(23A) in the Indian Stamp Act, 1899 and in the analogous provisions in the respective State Stamp Law legislations or by suitable notifications, enunciating the following:

“ 'Securitisation Deed'. - 'Securitisation Deed' means and includes every instrument evidencing assignment of assets including actionable claims (with or without assignment of underlying movable assets or underlying security), for the purposes of Securitisation of such assets.”

(b) Insertion of the following exemption for issue of PTCs pursuant to a Securitisation Deed in Article 19 of the First Schedule to the Indian Stamp Act, 1899 and in the analogous provisions in the respective State Stamp Law legislations or by suitable notifications, enunciating the following:

"Exemption: Certificate issued pursuant to a Securitisation Deed evidencing a right, title or interest of the holder thereof in the asset which is the subject matter of the Securitisation Deed."

(c) Insertion of the following exemption for stamp duty on any instrument of transfer of PTCs issued pursuant to a Securitisation Deed in Article 62 of the First Schedule to the Indian Stamp Act, 1899 and in the analogous provisions in the respective State Stamp Law legislations or by suitable notifications, enunciating the following:

"Exemptions: (e) of certificates issued pursuant to a Securitisation Deed"

(d) Insertion of the following Article in the First Schedule to the Indian Stamp Act, 1899, or by suitable notifications, enunciating the following:

Description of Instrument

Art. 57A. Securitisation Deed: A Securitisation Deed executed, by or in favour of, a Special Purpose Vehicle.

(e) *Proper stamp duty*

Rupee one (Rs 1/-) for every Rs One thousand (Rs 1000/-) or part thereof of the amount of consideration for such asset or as the case may be, the present market value of the asset which is the subject matter of such Securitisation Deed, whichever is greater subject to a maximum of Rs two lakh.

(f) While Government of Maharashtra, vide their special order of May 1994, had amended the Bombay Stamp Act to lower the stamp duties on instruments of securitisation to 0.1% for loans securitised or debt assigned with underlying securities, this benefit was extended where the underlying security was movable property. It is **recommended** that Government of Maharashtra could be approached once again to extend the benefit of the order of 1994 also to securitisation of debt involving immovable property.

9.7 Rationalisation of Registration Charges under the Registration Act

In terms of section 17(1)(b) of the Registration Act, a non-testamentary instrument purporting or operating to create, declare, assign limit or extinguish any right, title or interest in any

immovable property is required to be compulsorily registered with the Sub-Registrar of Assurances, for which registration charges are payable.

This imposes an onerous liability on the costs of undertaking the securitisation transaction.

9.7.1 **Recommendation** regarding rationalisation of registration charges

It is recommended that every State Government may prescribe a nominal sum, subject to a cap as registration for securitisation deed.

Instance of Maharashtra may be drawn upon for this purpose, wherein the Government has prescribed a ceiling of Rs 20,000 on the registration fees levied under the Registration Act.

Further, it is recommended that Section 17 of the Registration Act be amended to exclude the issuance and transfer or transmission of securities/certificates issued pursuant to a registered Securitisation Deed from the requirement of registration thereunder or a suitable notification be made in such regard.

Section 17(2) may be amended to insert a new sub-clause (xiii), which would read as follows, or by suitable notifications, specify the following:

"Any issuance of securities (including certificates) pursuant to a registered Securitisation Deed and the transfer or transmission of such securities or certificates are not required to be registered under the provisions of this Act."

9.8 **Income-tax Act, 1961**

Since the expression "securitisation" will be frequently used, this expression needs to be defined which may be as under:

Recommended Insertion of following **definition**:

'Securitisation' shall mean

- a) the transfer by sale or assignment of the whole or part of the assets including actionable claims by any entity which owns or has the rights, title and interests in the assets to a special purpose vehicle (SPV); and
- b) issuance of securitised debt receipts or securities, equity or certificates entitling holder thereof to the receipts of monies on account of the assets (including by virtue of any credit enhancement or liquidity facilities obtained by the SPV or specified person) by assignee under clause a) above.

The taxation issues, which arise in the process of asset securitisation, are discussed with reference to:

- ✓ Obligor
- ✓ Originator
- ✓ Special Purpose Vehicle (SPV)
- ✓ Servicer
- ✓ Investor

Obligor

- i. Under the Income-tax Act, 1961, tax is deductible at source (TDS) in case of payment of certain incomes. In the asset securitisation process the incomes would be payable to the SPV who in turn would pay to the investor. The tax deduction at source is at every point. Hence as per the current law, TDS would be deductible twice, once at the time of obligor paying the SPV and next at the time of the SPV paying the investors. This would involve locking of funds with the Income-tax Department and would have an impact on the yield, which the investor would get.

It is suggested that specific provision be made to exempt the obligor from deducting TDS and the primary responsibility of deduction of tax be on the SPV.

It may also be added that incomes arising out of asset securitisation in the hands of investors would have two components :

(a) redemption of principal amount ; and

(b) incomes on investment made .

It is suggested that TDS be applicable only on incomes on investments and not redemption of principal amount.

- ii. In case of obligor who is entitled to rebate under section 88 in the case of housing loans, in the event of asset securitisation, the repayment of such loan would be to the SPV. This may not strictly fulfill the conditions specified under section 88 for claim of rebate.

It is suggested that specific provision be made in the Income-tax Act to provide for rebate under section 88 even after the securitisation of such housing loans.

- iii. In case of obligor who is entitled to deduction of interest under Section 24 in the case of loans taken for purchase or repair of house in the event of asset securitisation, the interest paid to the SPV by the obligor fulfills all the conditions prescribed under Section 24. Hence no amendment is suggested to Section 24. **In order to avoid any confusion CBDT may issue necessary clarification in the form of a Circular.**

Originator

- i. Section 60 of the Income-tax Act, 1961 provides that in case of transfer of income without transfer of asset, the income would be taxable in the hands of the transferor. Securitisation of future flows of income of an asset which is not transferred may be taxable in the hands of the transferor e.g. lease finance receivable where transferor does not transfer the asset but transfers future installment or rent receivable.

It should be expressly provided in section 60 that such transaction would not be hit by the said provision.

- ii. In case of securitisation of future incomes receivable (future flow securitisation), the originator would get net present value (NPV) of future incomes at one stroke. If income tax is payable on this NPV of future incomes in year one, there would be an acceleration of taxation of income. This would affect cash flow of the originator. Further, if the future incomes cannot be accurately estimated at the time of securitisation for e.g. securitisation of oil reserves, securitisation of gold reserves, securitisation of future sales of goods to be manufactured, etc., the amount to be taxed would also undergo a change in the future on account of many factors like selling price, quantity, etc. A reference may also be made to the background paper on Accounting Treatment for securitisation (Annexure – II, para 15). It has been suggested therein that any money received for future cash flows by the Originator be treated as borrowing until its treatment as a securitised asset could be decided upon.

It is suggested that the taxation of future incomes be spread over the period to which the income belongs.

- iii. In case of securitisation of future incomes on a depreciable asset like lease transaction, question would arise whether depreciation should be granted on such an asset or not to the originator.

It is suggested that specific provision be made in the Income-tax Act to provide for allowance of such depreciation.

- iv. In case of asset securitisation, where collateral is provided by the Originator and the same does not flow back to the Originator (overcollateralisation), question would arise about its allowability as a deduction in computing income.

It is suggested that specific provision be made in the Income-tax Act to provide for deduction of such amount in the year in which such collateral is appropriated by the SPV.

- v. The provisions of Section 36(1)(viii) provide for a deduction in respect of special reserve created and maintained by a financial corporation which is engaged in providing long term finance for industrial or agricultural development or development of infrastructure facility in India or by a public company with the main object of carrying on business of providing long term finance for construction or purchase of houses in India for residential purposes of an amount not exceeding 40% of the *profits derived* from such business. The words "profits derived" used in the section would only include profit earned from the immediate source of financing the activities mentioned in the section. The securitisation of loans advanced to finance industrial or agricultural development or development of infrastructure facility or construction or purchase of houses can be recycled, if such loans can be securitised. The securitisation would involve acceleration of creation of assets, which are socially desirable. It is **suggested** that such entity (financial corporation as Originator) should continue to derive the benefit of Section 36(1)(viii) even after the loans have been taken off its balance sheet for accounting purposes after securitisation. The logic behind this suggestion is that the Originator gets either (i) lumpsum net present value of the differential in interest rate charged on the loans and coupon rate of the securitised paper (with suitable adjustments) or (ii) continues to enjoy the differential in interest rates over the tenure of the loans even after securitisation or (iii) gets service fee which is essentially with the objective of promoting infrastructure / housing etc. in the country.
- vi. Section 10(23G) of the Income-tax Act, 1961 provides for exemption of any income by way of dividend, interest or long term capital gain of an infrastructure capital fund or an infrastructure capital company from investments made by way of shares or long term finance in an enterprise wholly engaged in the business of developing, maintaining and operating any infrastructure facility. In case such an entity securitises future cash flows, a question would arise as to whether the incomes received as a result of securitisation would be eligible for exemption under section 10(23G). In other words, whether such income would be in the nature of interest or long term capital gains from investments made by way of shares or long term finance. It is suggested that such entities should continue to enjoy the exemption on such income even after asset securitisation.

SPV

- i. There should be a provision in the Act to provide for specific tax neutrality to SPV in the asset securitisation process. This is absolutely essential since absence of tax neutrality would itself defeat the entire purpose of asset securitisation. The SPV would receive cash flows out of which it would act as trustee for the amounts payable to the investors and balance would be retained as its income. The net profit of the SPV (fees retained for administrative and other matters net of expenses) which is not to be passed over to the investors should be liable to tax at the normal rate of tax.
- ii. The SPV should not be treated as representative assessee in terms of provisions of Section 160 and that the provisions of Section 161 should not be applicable to the SPV.

- iii. The provisions of Section 164 viz. charge of tax where the shares of beneficiaries in a trust are unknown should not be applicable to the SPV.

Servicer

The servicer receives fees for managing the assets of the SPV and carrying out administrative matters relating thereto. The income received by the servicer is taxable income and should be subject to normal income-tax under the Act.

Investor

- i. The concept of asset securitisation is new and unknown to individual investors in India. The securitisation process would accelerate creation of infrastructure facilities and houses. This is socially desirable.

It is suggested that benefit of Section 88 be made applicable to such investment made in any paper (through public issue) of SPV who has securitised assets. This incentive would encourage individual investors to participate in securitisation process and would go a long way in developing asset securitisation as a tool or instrument in the financial markets in the country as well as creation of good quality assets.

If the above suggestion is not acceptable, the Government would do well to at least grant the benefit of rebate under Section 88 on investment in any paper of SPV which has securitised any asset related to housing or infrastructure.

- ii. The incomes arising out of asset securitisation would be taxable in the hands of the investors as income. In order to encourage asset securitisation, it is suggested that the incomes, which flow out of asset securitised in next three years, should be made exempt from Income-tax (with no deduction of tax at source). In respect of asset securitised after three years, there is a need to continue partial deduction and the same can be achieved if income arising out of asset securitisation is included in Section 80L of the Income-tax Act, 1961.

9.9 Sales Tax

Under hire purchase transaction, the delivery of goods on hire purchase agreement / transfer of right to use is a deemed sale and attracts sales tax. In case of sales of receivable along with underlying assets by the originator to the SPV in a different state, the same would attract sales tax at the point of securitisation. This would defeat the purpose of asset securitisation since the working of yield on securitisation would undergo a change. In order to encourage asset securitisation specific exemption should be granted from sales tax to assets covered in the securitisation process.

9.10 Other Issues

In addition to the specific legal and tax issues outlined previously, securitisation in India suffers from certain market disadvantages which make it difficult at this stage for any company wishing to access this financing route to successfully execute a securitisation transaction. Following regulatory clarifications/directives are necessary to establish a conducive environment for market participants to examine securitisation as a viable financing option:

(i) Disclosure requirements in event of securitisation by FIs

If a Public Financial Institutions (“PFI”) wants to enter into a securitisation transaction involving the sale of its loan portfolio, it will face some restrictions under the PFI (Obligations as to Fidelity and Secrecy) Act, 1983 (the Act). The Act lays down certain restrictions on PFI’s from divulging any information relating to or to the affairs of its constituents. A PFI cannot divulge any information regarding its constituents except in the following cases:

- A. PFI can divulge information only to (a) Central Government (b) scheduled banks and (c) other PFI's.¹
- B. A PFI can also divulge information relating to its constituents if it is required by law or practice or usage customary to bankers.²

Any investor or SPV would have to be informed about the composition of the portfolio in which the investment is being made and would like to be acquainted with details on performance of the entity/ portfolio they are investing in. As per the law as it stands today if a PFI has to enter a securitisation transaction involving its loan portfolio, it can enter into such transactions only with other banks and PFIs as it can divulge any information regarding its borrowers only to PFIs and banks. Since no information can be divulged to the public or any corporate entity, securitisation involving the aforesaid parties will have to be ruled out unless it can be proved that it is a practice or usage customary among bankers to divulge such information.

A similar issue may concern disclosure of information by the banks as it would be necessary to establish that the disclosure forms part of usage customary amongst bankers.

Recommendation

A PFI or a bank can divulge information regarding its borrowers if required by law. If the SEBI or other appropriate authority such as the Government of India or Reserve Bank of India formulates disclosure requirements and norms for securitisation transactions, or permits disclosure by notification per se, as may be required by such investor or SPV for concluding securitisation, this hurdle could be overcome and securitisation will be facilitated.

Further, to avoid conflict with the existing secrecy laws,

- (i) For any future loans, the originators may insert a clause in the loan agreement which permits the Originator to divulge information to the SPV / Investors in the event of securitisation.
- (ii) For existing loans, the Originators may have to enter a supplementary agreement with each of the borrowers permitting the Originator to give the necessary information to the SPV / investors relating to the borrowers.

(ii) Easing of restrictive covenants on disposal of assets

Receivables are charged to working capital lenders as collateral. Experience has indicated that obtaining a No-Objection Certificate(NOC) from the lenders with the purpose of perfecting the sale, is a difficult and time-consuming process.

The RBI may assist operational issues arising in relation to securitisation transactions by advising FIs to convey their approval/disapproval at the earliest.

(iii) Securities Contract Regulation Act (SCRA) – to include securitised instruments

Securitized debt being a new instrument in the country does not find mention in any of the Acts including the SCRA. This acts as an impediment at various stages in the transaction such as issuance of the instrument, listing of the instrument on the stock exchanges etc. The Pass Through and Pay Through Certificates need to be defined in the SCRA since the characteristic of this new class of instrument is different from the other generic classes of either debt or equity. Justice Dhanuka Committee set up to review the securities laws has suggested that the definition of 'securities' under the SCRA be made comprehensive enough to include securitized instruments.

The Central Government may be requested to issue a notification under Sec. 2 (h) (iia) of the SCRA 1956 to include securitised instruments within the ambit of ‘securities’.
All the recommendations suggested in this chapter may be taken up in the short term.

Section 3 (2) of the Act.

Section 3(1) of the Act