Chapter 10 - Other Recommendations

10.1 General

Increased pressure on operating efficiency, on market niches, on competitive advantages, and on capital strength, all provide fuel for rapid changes. Securitisation is one solution to these challenges. The business considerations of disclosing information on one's business practices and collateral performance sometimes prevent many FIs to consider securitisation. The world is changing fast. Globalisation and advancements in technology have created new opportunities for large cross-border investments. Nations and national institutions have to open up to the rest of the world sooner or later to remain competitive.

Securitisation developed outside USA with the help of Government initiatives, by liberalising laws, adoption of stricter risk-based capital requirements and pressures from market participants to gain broader access to capital markets in order to optimise financing alternatives and pricing.

The Working Group had the benefit of presentations from and interaction with market intermediaries, regulators, industry experts, and international agencies (such as ADB & IFC) on various aspects associated with securitisation. The Group has identified certain areas warranting action from various quarters for the development of securitisation market in India. These measures with specific recommendations as discussed below are grouped into Short Term, Medium Term and Long Term.

The major recommendations on legal issues (short-term) are incorporated in Chapter 9. This chapter deals with other recommendations.

10.2 Short term measures

10.2.1 General Awareness

Future trends in securitisation of assets will not only be influenced by those FIs who are knowledgeable about this process, and therefore, aware of its potential but will also be affected by the level of knowledge in the financial community as a whole as well as the perception of the regulators. There is an urgent *need to increase the level of awareness* of the benefits and scope of securitisation among the financial community as detailed in Chapters 3 and 4 (particularly paras 3.20, 4.7 and 4.8). The most significant impact of securitisation arises from the placement of the different risks and rights of an asset with the most efficient owners. Securitisation provides capital relief, improves market allocation efficiency, improves the financial ratios of the FIs, can create a myriad of cash flows for the investors, suits risk profile of a variety of customers, enables the FIs to specialise in a particular activity, shifts the efficient frontier to the left, completes the markets with expanded opportunities for risk-sharing and risk-pooling, increases liquidity, facilitates asset-liability management, and develops best market practices. The process also paves way for creation of sophisticated institutions. Training Institutes of RBI/ FIs (Annexure I - para 9) can play an important and positive role in this regard.

10.2.2 Investment in securitised paper

10.2.2.1 The mindset of FIs and financial institutions has to undergo a change to accept asset-backed instruments as secured instruments. 'Pass through and pay through certificates' have a character distinct from traditional securities such as shares and debentures. This needs to be recognised by the FIs. RBI may need to set into motion the required change by issuing circulars clarifying that FIs may include securitised paper as investible securities in their investment policy (para 4.8.2 & 5.3 and Annexure IV).

Action Point: RBI, DBOD.

10.2.2.2 To facilitate investment by FIs in securitised paper, the risk weights and NPA norms on such paper need to be spelt out (para 4.8.2). A detailed discussion paper is enclosed to the Report as Annexure IV.

Action Point: RBI, DBOD.

10.2.2.3 To facilitate investment by NBFCs in securitised paper, guidelines regarding eligibility of the instrument for investment, risk weights and NPA norms would have to be defined for the NBFCs.

Action Point : RBI, DNBS.

10.2.2.4 The capital market regulator (SEBI) may need to stipulate that every securitisation issue be rated by minimum one credit rating for issues upto Rs. 100 crore and by two rating agencies for issues above Rs. 100 crore and that both the rating/s be made public along with the rating rationale (Annexure III).

Action Point : SEBI.

10.2.2.5 Insurance Companies and Provident Funds are amongst the large investors in the debt markets. While the Life Insurance Corporation of India have advised that under sec. 27A of the Insurance Act, 1938, the securitised paper will fall under Unscheduled and Unsecured Investments, stipulated at 15% of their Fund, other insurance companies as also the Insurance Regulatory Authority (IRA) too need to consider securitised paper as eligible investments (para 5.5).

Action Point : RBI, Implementation Committee.

10.2.2.6 Similarly, the PF Commissioner also may be requested to consider securitised paper as one of the eligible investments by PFs (para 8.1.8).

Action Point: RBI, Implementation Committee.

10.2.2.7 Disclosure norms and rating will provide the touchstone. The existing rating agencies have already acquired a fair degree of expertise in India through rating of structured obligations and other issues that are quite similar to securitisation (para 8.2.7). They will need to play an important role in increasing the confidence of investors and ensuring maximum transparency in transactions. The capability of the organisation to handle the complex securitisation transaction (Annexure I-para 9) may have to be evaluated in detail which may include the financial control, monthly reporting, pool extraction, portfolio MIS, and treasury skills (structuring, pricing, placement etc.). While the SPV's ability to make full and timely payment on the securities may be beyond doubt in view of the quality and quantum of the assets backing these securities, at times the insolvency of the originator may present a risk that the assets of SPV may be applied for purposes other than full and timely payment on the securities. 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 (para 8.2.7).

Action Point : Rating Agencies

10.2.2.8 SEBI /Stock Exchanges may need to lay down the listing requirements for various securities to be issued under securitisation process. These may include minimum issue size, eligible stock exchanges etc. (para 8.1.6). 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.

Action Point : SEBI

10.2.2.9 Steps are already being taken by the Ministry of Finance to extend the benefits of demat trading (exempting stamp duty on transfer), 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 (para 8.1.6).

Action Point :MOF

10.2.2.10 Foreign Institutional Investors can serve as major chunk of investors. They also have experience of investments in other EMs. Suitable guidelines / rules may have to be framed to encourage them to invest in securitised paper issued by Indian entities (para 6.10 & Ann. IV).

Action Point : Foreign Investment Promotion Board,
GOI and Exchange Control Department, RBI

10.2.3 Origination and SPV related issues

10.2.3.1 The Group has identified the characteristics of an SPV (para 7.4) . These may be published by the RBI as model guidelines for securitisation transactions. At the time of framing guidelines relating to public issuance of securitised paper, SEBI could draw upon the same characteristics. The WG recommends that the Originator should have the flexibility in choosing an appropriate legal structure for the SPV based on its individual requirements whether in the form of a company, trust (with or without a company as a trustee), MF, a statutory corporation, a society, firm, etc. Consequently, the provisions of the parent law for incorporation of such entity, i.e., the Companies Act, Trust Act, the Partnership Act, etc. will apply to the formation of such SPVs (para 7.3.1). There is lack of clarity as to whether securities issued by a trust are capable of being listed on a stock exchange. At present, MFs are the only trusts, which have been specifically empowered to issue such securities. SEBI could be requested to recognise such trustee companies and permit them to issue marketable securities as has been done for MF units (para 7.7.8). MF is considered as the closest available existing and regulated entity, which carries out an activity similar to securitisation. While it may not be feasible to accommodate the spirit of securitisation in its entirety within the MF Regulations, SEBI could consider framing a suitable set of guidelines for regulating the securitisation activity on the lines of the MF Regulations including structure of SPV, capitalisation and registration with SEBI (para 7.10). SPV in different forms may have to adhere to various recommendations given in para 7.4, 7.6.5, 7.7.8 and 7.9, which include:

- An SPV as a Company should be able to issue a new class of instrument viz. PTC that is repaid only from the performance of the *identified assets* held by it for the benefit of the investors in the PTC. This would prevent structural bankruptcy.
- This new class of instruments should not be treated a debt obligation of the SPV, but one representing an undivided interest of the investor in the underlying asset.
- The instruments are to be issued against a specified pool of assets (para 7.6.5).

SEBI may also clarify whether (a) MF as SPV can hold and dispose off assets pursuant to securitisation transaction; (b) MF can make private placement (c) MF can issue two or more classes of units (para 7.5).

Action Point : RBI, Implementation Committee and SEBI.

10.2.3.2 SPV as company would normally require registration with RBI under Section 45-IA of the RBI Act with the statutorily prescribed minimum capital of Rs. 200 lakh for a new company. However, in view of the fact that it would be a company which would undertake only the activity of asset securitisation and no other activity**,** all the companies incorporated for the purpose could be treated as a class of companies and would be regulated by one or the other Regulatory Authority viz. RBI or SEBI. Reserve Bank of India in

exercise of its powers under section 45NC of the RBI Act could exempt all such companies from the applicability of core provisions of RBI Act as has been done in case of the Stock Broking Companies (para 7.9.1). Non Banking Financial Companies' regulations of RBI will not be applicable in most of the structures of SPV as detailed in paras 7.9.1 and 7.9.4. Detailed guidelines need to be issued in this regard (para 8.1.7).

Action Point : RBI / SEBI

10.2.3.3 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. RBI may aid and assist operational issues arising in relation to securitisation transactions by advising banks to convey their approval/disapproval at the earliest. A suggestion has been made that working capital agreement between the FI and the borrower may exclude all receivables, which the FI may acquire in due course of time, to be charged to the bank.

Action Point : RBI, Implementation Committee/DBOD RBI.

10.2.4 Accounting Treatment

10.2.4.1 A Research Committee (RC) of the Institute of Chartered Accountants of India (ICAI) is bringing out a Guidance note (Annexure II) on the subject and the approach to be followed in this regard will have to be decided by the Committee and thereafter approved by the Council of the Institute (para 5.7). The WG had the benefit of the presence of a member of the Council of the Institute during its deliberations as a Special Invitee who was continuously in touch with the RC. The following illustrations of accounting treatment may form part of the final recommendations of the RC:

(i) An entity (Originator) transfers, in a securitisation arrangement, a portfolio of debts of Rs. 100 in consideration of Rs. 100 and there is *no recourse* to the Originator in any situation. Since all significant risks and benefits have been transferred, the asset will be `derecognised' (sold) in the books of the Originator.

The following journal entry may be passed:

	Rs.
Cash/Bank A/C Dr	100
To Debtors	100

(ii) An entity transfers title to a portfolio of debts of Rs.100 (for which expected bad debts are Rs.4) in return for proceeds of Rs.95 plus rights to a future sum, which depends on whether and when debtors pay. In addition, there is *recourse to the entity* for the first Rs. 10 of any losses. The arrangement would be presented as follows:

		Rs.
Debts subject to securitisation:	100	
Gross debts (after providing for bad debts)	96	
Less: non-returnable proceeds	(85)	
		11

The remaining 10 of the finance would be included within liabilities.
The following will be the journal entries in respect of the above:

Provision for Bad Debts	Dr.	4	
To Debtors			4

Cash/Bank A/C	Dr.	95	
To Debtors			85
To Liability towards recourse under the securitisation arrangement of the debts			10

(iii) In the case of *overcollateralisation*, in the books of the Originator, the non-refundable amount received may be shown as a deduction from the gross amount of the receivables and the net amount of receivables will be shown in the outer column. A disclosure should, however, be made in respect of the net amount of the receivables that a charge exists in favour of the Issuer.

(iv) Any money received for *future cash flows* by the Originator should be treated as a borrowing until its treatment as a securitised asset could be decided upon. The aforesaid treatment is justified in view of the fact that an asset or a liability should not be recognized which may arise in future. In accounting, only the past transactions or events can give rise to assets, liabilities, income and expenses.

(v) The *disclosure* requirements would depend upon the method of accounting finally decided by the RC. However, in general, the following disclosures may be made:

(a) the accounting policies followed,

(b) the characteristics of securitisation, i.e.,

(i) a description of the transferor's continuing involvement with the transferred assets including, but not limited to, servicing recourse and restrictions on retained interests,

(ii) cash proceeds, and

(iii) gain or loss from securitisation.

Further, disclosures regarding the quantum of assets securitised and attendant credit enhancements offered by the originators should be disclosed by the Auditors in their statutory report.

(vi) Issuer (SPV) may maintain balance sheet of its own. Considerations similar to those related to accounting for securitisation in the books of the originator also apply in relation to accounting in the books of the Issuer. In the books of issuer, mirror entry to the entry passed by the originator should be passed. For example, on the facts given in para (i) above, the following entry would be passed :

Debtors A/c. Dr.
To Cash / Bank A/c.

Action Point : ICAI.

10.2.4.2 The Research Committee of ICAI may give further consideration to the following issues:

- Accounting treatment in case of overcollateralisation to ensure that the investors are not affected by the bankruptcy of the Originator.
- Accounting in the books of SPV for Pay Through Certificates.
- Inflows of proceeds of securitisation in the books of Originator without corresponding transfer of assets by Originator.

Action Point : ICAI.

10.2.4.3 If the Originator provides credit enhancements in the form of a limited guarantee or pool substitution to a certain extent, there is said to be some recourse back to the Originator. In the absence of clear accounting guidelines, accountants find it difficult to classify such transactions as a sale treatment rather than a financing treatment. RC may examine the issue.

Action Point: ICAI.

10.2.5 Disclosures

The WG recommends adequate disclosure norms for an "informed" decision by investors and maximum transparency for the financial community including the regulators. For this purpose, an 'Offer document' has been prepared (para 8.1.5 & Annexure III) which should serve as a best practice model. The document should include, inter-alia, the following information:

- Description of the assets (summary of pool, geographical distribution etc.)
- Transaction structure
- Declaration on the historical performance
- Information about Originator
- Description of the issuer
- End use of the funds
- Statement of risk factors including legal risk, cash flow risk, Third party risks (including credit enhancer risk, servicing risk etc.)
- Disclaimers of the liabilities except those explicitly specified.

The Offer Document should give rating rationale, which should seek to comment on the quality of the receivables, payment structure, adequacy of the credit enhancements, risks and concerns for investors and the mitigating factors etc.

There is need for continuous disclosures i.e. updating of information at regular intervals.

The issue of disclosures may be addressed in two ways:

a) The regulator may specify, *ab initio*, the type of asset classes that could be securitised and specify the disclosure requirements separately for each asset class.

b) The regulator may lay down general norms of disclosure which would be common to all asset classes (for example, information pertaining to third party risk, cash flow risks etc) and retain the right to scrutinise and approve specific disclosures that may be required for separate asset classes.

Instruments of securitisation may be offered to investors either by way of private placement or by public issues. Although disclosures in regard to private placement of debt is not regulated by any agency at the moment, it is recommended that there should be certain minimum disclosures even for private placements for best practice, that could be modelled on the lines described in Annexure III. For public issues such disclosure requirements should be made mandatory by the regulator.

Action Point: SEBI

10.2.6 Prudential Norms

The WG had detailed discussions on the prudential norms to be followed by the financial institutions in the process of undertaking securitisation (Annexure IV). After the recommendations of the WG in this regard are accepted (as listed in Annexure IV), RBI may issue operative guidelines on the criteria for true sale for FIs to claim off balance sheet treatment for the securitised assets as well as credit enhancement, servicing of securitisation schemes and also for providing liquidity support. Prudential guidelines may be framed on the lines of the model guidelines given in Annexure IV for FIs, primary dealers etc. by RBI.

Other regulators such as NHB could draft similar guidelines for Housing Finance Institutions, NABARD for regional rural banks, etc. (para 8.1.8).

The criterion for 'true sale' is the basic to the regulatory guidelines and would determine the capital relief. The proposed criteria would include the legal method and extent to which the assets have been isolated from the Originator and the recourse to the Originator. This will also include:

i. Transaction price for transfer of assets from Originator to SPV should be market based and at arm's length basis.

ii. The transferred assets should have been isolated from the transferor i.e. put beyond the reach of transferor and its creditors even in bankruptcy. Transferee/SPV and holders of beneficial interests in the assets of SPV obtain the right to pledge or exchange the transferred assets free of any restraining condition.

iii. The transferor does not maintain effective control over the transferred assets through an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity.

iv All risks and rewards of the seller in respect of the assets should have been fully transferred to SPV.

As regards investment in ABS/MBS by FIs etc., specific instructions should be issued to treat the investment in securitised papers outside the present 5% limit in shares and debentures of corporate entities. Various departments of RBI (Department of Banking Operations & Development, Urban Banking Department, Rural Planning & Credit Department), Ministry of Finance, Insurance Regulatory Authority, Provident Fund Commissioner etc. may formulate specific guidelines for investments in securitised paper (para 8.1.8). Once the regulatory framework is in place, the developments in the financial sector should be monitored through reporting mechanism. A database should be maintained in the securitisation activities. The regulatory guidelines may be reviewed after one year based on the experience gained in the intervening period. If needed, special studies may be undertaken to assess the impact of securitisation on the capital, debt and money market, balance sheets of FIs with regard to risk profile, capital arbitrage, cherry picking, etc.

Action Point : RBI (DBOD/DNBS/IDM Cell/UBD/RPCD), IRA, SEBI, PF Commissioner, MOF, etc.

10.2.7 Other issues

The concerned department/s of RBI may re-examine the issue of securitisation of export receivables keeping in view the international practice and the huge potential to securitise export receivables. RBI may consider to issue a clarification that exporters would continue to be eligible for concessional export finance in the event of a securitisation transaction being carried out as long as upfront purchase consideration is paid in Foreign Currency (para 4.5).

Action point: Exchange Control Dept. and Industrial Export and Credit Dept. of RBI.

10.3 Medium-term measures

10.3.1 In India, certain structured finance transactions have so far been entered into in the name of securitisation transactions. The Group has identified certain impediments for true asset securitisation to take place as a result of lack of clarification in respect of provisions of certain statutes / lack of adequate provisions relating to securitisation built in statutes. Reserve Bank of India may, therefore, take up these issues with MOF, CBDT, etc (Chapter 9). While these issues should be taken up in the short-term, the same should continue to be followed up in the medium-term, wherever needed.

Action Point: RBI, Implementation Committee.

10.3.2 Credit information is not readily available for investors to take an informed view on the performance of the assets. For this purpose, adequate disclosures in the offer document by the issuers are important. The issuer may disclose the required information as indicated in the Annexure III on disclosure norms. In this regard, Credit Bureaus may also play an important role. A Working Group of Reserve Bank of India has already considered various aspects of setting up Credit Bureaus, including the problems of secrecy laws which may go a long way in providing data on the past performance of the obligors including the delinquency rates in different pools of assets (para 5.10).

Action Point : RBI, Implementation Committee

10.3.3 Originators serving as Administrators may gear up these internal control systems to segregate pool of securitised assets from other assets (para 3.14 & 8.2.1.1).

10.3.4 Standardisation should be attempted. This refers to FIs and other lenders adopting common formats, practices and procedures in loan origination, application, documentation, and administration (servicing) to generate homogenous pool of assets (para 5.11).

Action Point : RBI, Implementation Committee.

10.3.5 The Originators need to have a minimum viable amount of quality assets to make the securitisation transaction attractive in view of some minimum expenses to be incurred for fees for structurer, rating agencies, lawyers, auditors, road shows, etc. (para 3.20 & 5.9). Financial Institutions may review their management information systems and computer skills to meet the challenges of securitisation. (para 5.10).

10.3.6 The Indian financial community can draw lessons from U.S. experience of securitising non-performing assets (NPAs). As detailed in para 6.1.7, such assets can be securitised if they are managed well and have the potential for appreciation (or capable of fetching higher price for investors on sale than the discounted purchase price). Securitisation can be part of a general programme to rehabilitate financial systems. As the experience so suggests, securitisation can be used both to sell good assets held by bad FIs and to dispose off assets that are themselves impaired. The Japanese Government also sees securitisation as the solution to Japan's bad loan crisis (para 6.3.2).

10.4 Long-term measures

10.4.1 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. It will be worthwhile to draw lessons from U.S. experience of implicit and explicit Government guarantees in MBS as detailed in para 6.1.

10.4.2 Two major benefits of securitisation have been emphasised in the infrastructure sector (i) cost of funding will be reduced; (ii) larger number of investors can be approached for meeting the infrastructure needs. The support of a guarantee company could be considered towards extending credit enhancements especially for the infrastructure sector.

Action Point: RBI, Implementation Committee.

10.4.3 A host of financial intermediaries (servicers, market makers, etc.) with specialised skills are also necessary to provide the building blocks for market growth (para 3.9, 5.4 & 8.2.8).

10.4.4 Fiduciary Service Providers assist the Originator / Administrator in resolution of any servicing related issues and preparation of the 'Servicer Report'. Other functions include periodic 'waterfall' calculation, periodic 'trigger monitoring and liaisoning with Originator / Administrator and other agencies for transaction data. New entities may emerge to serve as Fiduciary Service Provider (para 8.2.5).

10.4.5 Although, it has been suggested that RBI may take up with MOF / CBDT etc. regarding clarification on amendments to certain statutes, as short and medium term measures, the Group also opined that as a long term measure, GOI may consider bringing out an ***umbrella legislation*** covering all aspects of securitisation.

Action Point: GOI / RBI

10.5 Time Frame

The following time frame is suggested for implementing the three categories of suggestions:

Short-term	:	1 to 6 months
Medium-term	:	6 to 12 months
Long-tern	:	12 to 24 months

10.6 Conclusion

It is suggested that an *Implementation Committee* be set up within the RBI for following up on the different measures suggested by the Group and to act as the product champion for securitisation in the country. This is considered necessary on account of the lengthy processes involved in amending the various statutes to facilitate early growth of securitisation markets.

In summary, since India has the benefit of testimonial access to the value of securitisation from developed markets as well as a few EMs, it should be possible to leapfrog the development stage through a combination of gentle legal / regulatory support coupled with encouragement of local innovation. In the medium term, specialised institutions such as NHB, Infrastructure Development & Finance Company and such could be encouraged to focus on providing an impetus to the growth of this market by acting as credit enhancers and market makers in preference to the presently envisaged role of acting as refinance agencies to more optimally utilise the capital and support allocated to them.

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