Report of The In-house Working Group On Asset Securitisation

Reserve Bank Of India

Mumbai

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Foreword

The need for asset securitisation is being felt in three major areas in the Indian context - mortgage backed securities, infrastructure sector and other asset backed securities. Although securitisation offers numerous benefits in the form of capital relief, asset-liability management, liquidity, risk tranching etc., yet there are a number of legal, regulatory, accounting, disclosure, psychological and other issues which need to be sorted out. Besides, the financial intermediaries need to engage themselves prudently in the securitisation process. Reserve Bank of India (RBI), as a facilitator, has attempted to address most of these issues by drawing upon the international experience and valuable ideas from the market players, rating agencies and industry experts in India. The in-house working group (WG) set up by RBI on the subject has now presented its report.

2. The WG records its appreciation for the presentations made by different organisations and the inputs received from ICAI, ICICI, National Housing Bank, and SBI Capital Markets Ltd. in drafting the report. The contributions made by Shri. M. Palanisamy, DGM and Shri. Mohindar Kumar, AGM of RBI in organising the meetings and providing necessary technical support etc. are acknowledged with thanks.

(V.S.N. Murty)

Chief General Manager-in-Charge
Department of Non-Banking Supervision,
Reserve Bank of India, Mumbai
December 20, 1999

TABLE OF CONTENTS

EXECUTIVE SUMMARY I

CHAPTER 1 INTRODUCTION & METHODOLOGY 1

1.1 INTRODUCTION 1
1.2 BACKGROUND 1
1.3 WORKING GROUP – MEMBERS, SPECIAL INVITEES & TERMS OF REFERENCE 1
1.4 METHODOLOGY 4
1.5 STRUCTURE OF THE REPORT 5

CHAPTER 2 MEANING AND STRUCTURE OF SECURITISATION TRANSACTION 6

2.1 MEANING 6
2.2 PARTIES TO A SECURITISATION TRANSACTION 8
2.3 PASS AND PAY THROUGH STRUCTURES 9
2.4 ASSET AND MORTGAGE BACKED SECURITIES 9
2.5 CREDIT ENHANCEMENT 10
2.6 FUTURE FLOW SECURITISATION 11

CHAPTER 3 SECURITISATION – MOTIVATION AND BENEFITS 16

3.1 GENERAL 16
3.2 CAPITAL RELIEF 17
3.3 CAPITAL PLANNING 17
3.4 CAPITAL REQUIREMENT 18
3.5 INCOME STATEMENT EFFECT 19
3.6 INFLUENCE ON FINANCIAL RATIOS 19
3.7 PROVIDING MARKET ACCESS 21
3.8 OVERCOMING CONSTRAINTS OF MARKET SEGMENTATION 21
3.9 STRATEGIC TOOL 22
3.10 LIQUIDITY 23
3.11 RISK TRANCHING / UNBUNDLING 23
3.12 ASSET-LIABILITY MANAGEMENT 24
3.13 DIVERSIFICATION OF ASSETS 25
3.14 SYSTEMS/REPORTING 25
3.15 ORIGINATOR DISCIPLINE 26
3.16 CLIENT RELATIONSHIP EFFECT 26
3.17 POOLING 26
3.18 OTHER BENEFITS TO FIS 27
3.19 BENEFITS TO CUSTOMERS 27
3.20 OVERALL BENEFITS TO THE ORIGINATORS AND THE FINANCIAL SYSTEM 27
3.21 CONCLUSION – EMS 29

CHAPTER 4 SCOPE OF SECURITISATION AND INDIAN EXPERIENCE 31

4.1 INTRODUCTION 31
4.2 MORTGAGE BACKED SECURITIES (MBS) 31
4.3 ASSET BACKED SECURITIES (ABS) – EXISTING ASSETS 32
4.4 SECURITISATION OF INFRASTRUCTURE RECEIVABLES 33
4.5 FUTURE RECEIVABLES: 38
4.6 THE INDIAN EXPERIENCE 40
4.7 GENERAL 46
4.8 FUTURE PROSPECTS 47

CHAPTER 5 IMPEDIMENTS TO SECURITISATION 50

5.1 GENERAL 50
5.2 INVESTOR BASE 51
5.3 CULTURAL FACTORS 51
5.4 CAPITAL MARKET INFRASTRUCTURE 52
5.5 REGULATORY ENVIRONMENT 52
5.6 LEGAL PROVISIONS 52
5.7 ACCOUNTING 53

5.8 Taxation 53
5.9 Quality of assets 54
5.10 System Deficiencies 54
5.11 Standardisation 54

CHAPTER 6 INTERNATIONAL EXPERIENCE 56

6.1 United States 56
6.2 Europe 63
6.3 Japan 65
6.4 Australia 65
6.5 Thailand 66
6.6 Indonesia 68
6.7 Argentina 69
6.8 Hong Kong 73
6.9 Morocco 73
6.10 General 77

CHAPTER 7 SPECIAL PURPOSE VEHICLE 78

7.1 Concept 78
7.2 SPVs in other Countries 78
7.3 SPV in the Indian context 81
7.4 Key features desired in an ideal SPV 82
7.5 Company, Trust or MF 83
7.6 Company as a SPV 86
7.7 Trust of which a Company is a Trustee (Trustee Company as SPV) 87
7.8 MF AS SPV 89
7.9 Further recommendations for different forms of SPV 90
7.10 Conclusion 93

CHAPTER 8 ROLE OF REGULATORS & OTHER AGENCIES 94

8.1 Role of Regulators 94
8.2 Role of Other Agencies 99

CHAPTER 9 LEGAL & TAXATION RECOMMENDATIONS 103

9.1 Amendments required to various statutes to facilitate securitisation 103
9.2 Transfer of Property Act, 1882 105
9.3 Code of Civil Procedure, 1908 109
9.4 Companies Act, 1956 109
9.5 SEBI (Mutual Fund) Regulations, 1996 110
9.6 Rationalisation of the stamp duty structure and registration charges 111
9.7 Rationalisation of Registration Charges under the Registration Act 115
9.8 Income-tax Act, 1961 115
9.9 Sales Tax 120
9.10 Other Issues 120

CHAPTER 10 OTHER RECOMMENDATIONS 123

10.1 General 123
10.2 Short term measures 123
10.2.1 General Awareness 123
10.2.2 Investment in securitised paper 124
10.2.3 Origination and SPV related issues 126
10.2.4 Accounting Treatment 127
10.2.5 Disclosures 130
10.2.6 Prudential Norms 131
10.3 Medium-term measures 132
10.4 Long-term measures 133
10.5 Time Frame 134
10.6 Conclusion 134

ANNEXURE – I PRESENTATIONS GIVEN BY OUTSIDE ORGANISATIONS TO THE IN-HOUSE WORKING GROUP 136
SBI CAPITAL MARKETS LTD. 136
NATIONAL HOUSING BANK (NHB) 136
ICRA LTD. (ICRA) 138
ICICI LTD. (ICICI) 139
ILFS 140
CITI BANK 140
DUFF & PHELPS CREDIT RATING INDIA PVT. LTD. (DCR INDIA) 141
CREDIT RATING INFORMATION SERVICES OF INDIA LTD. (CRISIL) 142
CONSULTANT, ASIAN DEVELOPMENT BANK (SHRI S.P. GHOSH) 143
ANZ INVESTMENT BANK 144

ANNEXURE – II ACCOUNTING TREATMENT 146
APPROACHES TO ACCOUNTING TREATMENT FOR SECURITISATION 146
ACCOUNTING TREATMENT FOR SECURITISATION 147
REVOLVING PERIOD SECURITISATION 152
DISCLOSURES 153
VALUATION OF INVESTMENTS IN LOAN NOTES BY NOTEHOLDERS 154
APPENDIX ' A ' 155

ANNEXURE – III DISCLOSURE OF INFORMATION TO INVESTORS 156
INTRODUCTION : 156
INFORMATION REQUIREMENTS 157
CONTINUING DISCLOSURES 166
CONCLUSION : 167

ANNEXURE - IV PROPOSED PRUDENTIAL GUIDELINES 168
OBJECTIVES OF SECURITISATION: 168
RATIONALE FOR REGULATION: 168
REPORTING: 169
FOCUS OF THE GUIDELINES: 170
CRITERIA FOR TRUE SALE: 171
GUIDELINES FOR PROVIDERS OF CREDIT ENHANCEMENT FACILITIES : 173
GUIDELINES FOR SERVICE PROVIDERS: 175
ADDITIONAL GUIDELINES FOR SPECIAL STRUCTURES: 176
INVESTMENT IN ABS/MBS: 177
APPENDIX 180

Executive Summary

The introduction of financial sector reforms in India has led to innovations in financial markets and instruments. One of the most prominent developments in the international finance in recent times that is likely to assume even greater importance in future is 'securitisation'. Securitisation is the process of pooling and re-packaging of homogenous illiquid loans into marketable securities. Increased pressure on operating efficiency, on market niches, on competitive advantages, and on capital strength, all provide fuel for rapid changes. Securitisation is one of the solutions to these challenges.

2. Reserve Bank of India, as a facilitator, has attempted to explore the intricacies of securitisation as a process of financial engineering and its applicability to the Indian financial system especially in the mortgage and infrastructure sectors. The in-house Working Group constituted by the Bank had the benefit of presentations of and interaction with market intermediaries, regulators, industry experts and international agencies on various aspects associated with securitisation.

3. The report defines asset securitisation and makes a reference to future flow securitisation. Motivation and benefits in the form of capital relief, improvement in return on equity and return on assets, use as a strategic tool, asset liability management, improved liquidity, upgradation in system, Originator discipline, etc. have been highlighted.

4. Various impediments viz., lack of investors' base, capital market infrastructure, regulatory framework, legal provisions, accounting and taxation issues besides good quality assets, past data and standardisation of documents have been identified. In the process of exploring opportunities in India, the ideal conditions for success of securitisation in USA and other countries are highlighted.

5. Experience of securitisation in a few developed countries (USA, Japan, Australia, etc.) and emerging markets like Thailand, Argentina and Morocco has been discussed in detail. The report also identifies securitisation of impaired assets.

6. The disclosure norms and rating will provide touchstones. The Offer Document should give rating rationale which should seek to comment on the quality of the receivables, payment structures, adequacy of the credit enhancement, risks and concerns for investors and the mitigating factors, etc. 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.

7. True sale characteristics of securitisation transactions are required to be reflected in the books of accounts, statements to be furnished to the concerned regulators as also to the tax authorities. Since there are no guidelines for accounting treatment of these transactions, the accounting procedures with appropriate guidelines need to be framed by the Institute of Chartered Accountants of India for the sake of uniformity. A background paper has been prepared in this regard and attached to this report which may serve as a guide in the interregnum. The background paper includes a few illustrations for the guidance of the financial entities.

8. The role of various regulators (RBI, SEBI, etc.) and other agencies / entities has also been discussed.

9. The recommendations have been categorised into short-term, medium-term and long-term with definite timeframe in each category. The major recommendations on legal issues (short-term) are incorporated in Chapter 9. These include:

i) Defining securitisation in the Transfer of Property Act to lend uniformity of approach and restrict the benefits provided by law/regulation for genuine securitisation transactions.

ii) Rationalisation of stamp duty to make it uniform at 0.1 per cent for all securitisation transactions. Attempts may be made to bring the subject under the purview of Indian Stamps Act 1889 from the State Stamp Acts.

iii) Reduction of registration charges by amending Section 17(2) of the Registration Act.

iv) Inclusion of securitised instruments in Securities Contract Regulation Act.

v) SEBI may consider removal of prohibition on investment in mortgage backed securities by Mutual Fund Schemes.

vi) Tax neutrality of Special Purpose Vehicle. Recommendations for tax reforms also include the spread of upfront income received by Originator over the tenure of the loan securitised, extension of benefits under Section 88 of Income Tax Act for repayment of housing loans after the loans have been securitised etc.

10. Other recommendations are summarised below:

    i) The most significant impact of securitisation arises from the placement of different risks and rights of an asset with the most efficient owner. The training institutes of the financial institutions should attempt to spread awareness of the benefits and scope of securitisation increasingly among financial community.

    ii) Spell out the risk weights and NPA norms on securitised paper. Insurance Companies and Provident Funds need to be encouraged to invest in the securitised paper. Besides, suitable regulatory framework may have to be evolved to encourage Foreign Institutional Investors.

    iii) Listing requirements for various securities to be issued may be stipulated which may include minimum issue size, eligible stock exchanges etc.

    iv) Include the securitised paper in demat trading.

    v) While identifying the key characteristics of special Purpose Vehicle (SPV) to keep the structure "remote" from the bankruptcy of the Originator, the Group recommends flexibility in the structure of SPV. SEBI may formulate detailed guidelines in this regard.

    vi) Accounting treatment should enable the 'off balance sheet' effect for securitised assets. Such treatment for future flow securitisation, credit enhancer etc. has been clarified. A Research Committee of the Institute of Chartered Accountants of India is already working on minute details of accounting treatment.

vii) Adequate disclosure norms are recommended for an 'informed" decision by the investor. A model Offer document has been attempted by the Group to give information on description of assets, historical performance, end use of funds, transaction structure, and statement of risk factors. The Group also recommends continuous disclosures.

viii) The report has suggested prudential guidelines for banks, developmental financial institutions, non-banking finance companies, etc. including broad creteria for true sale. Model prudential guidelines have been prepared which incorporate issues such as off balance sheet treatment, credit enhancement, servicing, etc.

ix) *Medium term* measures include increased flow of information thorough credit bureaus, standardisation of documents, improvement in the quality of assets, upgradation of computer skills and exploration of the possibilities of securitising non-performing assets.

x) In the *long term*, certain insurance/guarantee institutions may have to develop to give comfort to investors especially in infrastructure and mortgage sectors. There is a need for developing a host of financial intermediaries with specialised skills to provide the building blocks for market growth. GOI may consider bringing out an *umbrella legislation* covering all aspects of securitisation.

xi) An *Implementation Committee* may be set up within RBI for following up on different measures suggested by the Group and to act as product champion for securitisation in the country.

11. The Group feels that the FIs in future will be judged more by the informal strength and capital base rather than the external support from the Central Bank or Government. Market penetration of FIs in the area of loan origination in future will be determined more by the volume of loans originated during a period than by the amount of loans owned at a particular point of time.

Chapter 1 Introduction & Methodology

1.1 Introduction

The Governor, during discussions held in March, 1999 with the Chief Executive Officers of some of the Development Financial Institutions (DFIs) on *infrastructure financing*, had suggested that institutional initiatives should be triggered to lay the road map for development and growth of Asset Securitisation in the Indian Financial System. He had accordingly directed constitution of an in-house Working Group (WG), to examine the issues pertaining to development of the market for asset securitisation in its entirety.

1.2 Background

The need of asset securitisation is being felt in three major areas in the Indian context - Mortgage Backed Securities (MBS), Infrastructure Sector and other Asset Backed Securities (ABS). National Housing Bank (NHB) is currently steering a pilot project on mortgage securitisation. RBI has been holding periodic informal interactions/meetings with FIs and select banks to discuss the key issues relating to development of infrastructure. While reviewing progress in the power sector, it was observed that FIs / banks had made considerable progress in the financing of projects in this sector and that they were already close to their prudential exposure limits. It was, therefore, felt necessary to develop securitisation and other allied modalities so that FIs could offload their initial exposure and make room for financing new projects. With the introduction of financial sector reforms in the early nineties, banks and FIs, particularly the NBFCs are entering into the retail business in a big way generating large volumes of homogeneous classes of assets (auto loans, credit cards etc.) leading to the attempts for ABS by a few players in the Indian financial sector. During the process, it was observed that there were a number of legal, regulatory, psychological and other issues, which needed to be sorted out to facilitate the growth of securitisation. It was observed that since legislative amendments to various Acts is a time consuming process, it may be beneficial to identify the issues of short-term nature which could be tackled on a priority basis, and, issues of long term nature could be separately dealt with. It was, therefore, suggested in June 1999 that an in-house WG may be set up to examine the issues involved and recommend as to how asset securitisation could be introduced in the Indian financial system.

1.3 Working Group – Members, Special Invitees & Terms of Reference

1.3.1 Constitution

The in-house Working Group consisted of the following senior officers of Reserve Bank of India as members:

1	Shri V.S.N. Murty, Chief General Manager-in-Charge, Reserve Bank of India, Department of Non-Banking Supervision (DNBS), Central Office, World Trade Centre-I, Mumbai 400 005.	Chairman
2	Shri S. R. Hegde, Addl. Legal Adviser, Reserve Bank of India Central Office (CO), Fort, Mumbai 400 001.	Member
3	Shri A.S. Rao, Deputy General Manager, Reserve Bank of India CO, Internal Debt Management Cell, Fort, Mumbai 400 005.	Member
4	Shri Rajesh Verma, Deputy General Manager, Reserve Bank of India, Department of Banking Operations and Development, CO, World Trade Centre-I, Mumbai 400 005.	Member
5	Shri S.D. Sapkal, Deputy General Manager, Reserve Bank of India, Industrial and Export Credit Department, CO, Fort, Mumbai 400 001.	Member
6	Shri K. K. Vohra, Deputy General Manager, Reserve Bank of India, DNBS, CO, World Trade Centre-I, Mumbai 400 005.	Member-Secretary

The following Special Invitees were requested to participate in all the major meetings of the Group:

Shri Pratip Kar, Executive Director, Securities & Exchange Board of India, Mittal Court, 'B' Wing, 1st floor, 224, Nariman Point, Mumbai 400 021.	Special Invitee

Shri K.S. Vikamsey,
Member Council,
Institute of Chartered Accountants of India,
M/s. Khimji Kunverji & Co., Suit 52,
Bombay Mutual Bldg., Sir P.M. Road, Fort,
Mumbai 400 001.

Special Invitee

Shri R. V. Verma,
General Manager,
National Housing Bank, Core-5A, 3rd floor,
India Habitat Centre, Lodhi Road,
New Delhi 110 003.

Special Invitee

Shri Birendra Kumar,
Managing Director, SBI Capital Markets Ltd.,
202, Maker Towers 'E', Cuffe Parade,
Mumbai 400 005.

Special Invitee

Shri Ananda Mukerji,
General Manager,
ICICI Ltd., C-23, G Block,
Bandra-Kurla Complex,
Mumbai 400 051.

Special Invitee

Besides, representatives from ICRA and CRISIL attended the deliberations of the Group. There were a few other officers from RBI as well as other organisations referred to above who contributed actively in the organisation and deliberations of the meetings and finalisation of the report.

1.3.2 Terms of reference

The Working Group was assigned the following terms of reference:

(i) to examine the regulatory framework for securitisation of assets such as structure and scope of SPV, capital adequacy standards, investor base, operational details, exposure of banks as investor etc.

(ii) to recommend proper and transparent accounting and disclosure standards;

(iii) to examine applicability of NBFC directions;

(iv) to suggest comprehensive guidelines;

(v) to suggest amendments to various statutes for promoting securitisation of debts in India; and

(vi) any other aspects relevant to asset securitisation.

1.4 Methodology

The WG held nine meetings during the period from July 3 to December 13, 1999 in Mumbai. The WG had the benefit of oral presentations (Annexure – I) made by SBI Capital Markets Ltd., National Housing Bank, the three rating agencies - ICRA, DCR and CRISIL, Citi Bank, Infrastructure Leasing and Finance Services Ltd., ICICI, ANZ Investment Bank, Consultant to Asian Development Bank (Shri S. P. Ghosh) etc. The Chairman of the Group also had the opportunity to interact personally with the officials from International Finance Corporation (IFC), the Chief Executive Officer of the ANZ Investment Bank and a few other international agencies. The Chairman's secretariat interacted with international academicians, global industry specialists, international rating agencies, international investment banks, Bank for International Settlement etc.

1.4.1 Literature research

Some of the previously written publications, articles from financial journals, past research, etc. were analysed. The report incorporates extracts from the thesis titled 'Securitisation of Assets of Financial Institutions' written by the Member-Secretary during his studies abroad (1997-98). Besides, the literature received from various financial institutions, Rating Agencies, ADB, IFC, was also made use for compilation of the report.

1.4.2 Meetings

Besides the formal meetings attended by the Members and Special Invitees, there were numerous meetings organised by various sub-groups. Members and Special Invitees continued to interact with Specialised Agencies. The Special Invitee from ICAI had a few rounds of discussion with Research Committee of ICAI constituted for the purpose.

1.4.3 Other resources

The Group received a clarification from L.I.C. that Securitisation Instruments are part of discretionary investments under Section 27(A)(2) of Insurance Act, 1938. The reply also contained a few suggestions. As a result of active follow up of the oral presentations, a few valuable suggestions were received from Shri S.P. Ghosh, Consultant, ADB, ANZ Investment Bank, Citi Bank, NHB, ICICI, CRISIL etc. ICICI, NHB and SBI Capital Markets contributed actively in the drafting of various chapters.

1.4.4 Sub-Groups

The Group had the benefit of detailed deliberations by the sub-Groups on the following subjects:

- Legal Framework

- Special Purpose Vehicle
- Disclosure Norms
- Prudential Norms
- Accounting Treatment
- Taxation Issues

1.5 Structure of the Report

The contents of various chapters that follow are closely related. The report starts with meaning of securitisation in Chapter 2, which also includes a reference to future flow securitisation. Securitisation can be successful if legal, regulatory and psychological barriers are minimised / eliminated and all the concerned agencies understand the benefits. For this purpose, the motivation and benefits of securitisation are discussed in detail in Chapter 3. Scope of securitisation including some attempts in India during the last few years are highlighted in Chapter 4. While the main impediments in the form of legal provisions are discussed exclusively in detail in Chapter 9, the other impediments are identified in Chapter 5. Securitisation took its birth in USA and has spread in many developed and developing countries. It is important that Indian financial community draws some lessons from experiences of these countries and adopts the same in India according to the local conditions. Chapter 6 deals with international experience. The whole structure of securitisation revolves around Special Purpose Corporation or Special Purpose Vehicle (SPV). It is necessary to understand the pros and cons of various forms of SPV. An exclusive chapter (Chapter 7) has been devoted for the purpose. The chapter also deals with applicability of Non-Banking Financial Company (NBFC) directions. Role of various other agencies including the regulators is discussed in brief in Chapter 8. Legal issues including recommendations are highlighted in Chapter 9. The chapter discusses in detail the major impediments in the form of stamp duties and tax related matters. The concluding chapter (Chapter 10) highlights other recommendations – short, medium and long-term and the suggested time frame. This Chapter refers to accounting treatment for securitisation transactions, disclosure norms and prudential guidelines. It recommends enactment of umbrella legislation and also incorporates suggestion for an Implementation Committee to expedite follow up of various suggestions. References to various paras in other chapters are made in the concluding Chapter to give the background and rationale of the recommendations. The word FI (financial institutions) referred in the subsequent chapters includes banks, financial institutions and the non-banking finance companies.

Chapter 2 Meaning and Structure of Securitisation Transaction

2.1 Meaning

One of the most prominent developments in international finance in recent decades and the one that is likely to assume even greater importance in future, is securitisation. Securitisation is the process of pooling and repackaging of homogenous illiquid financial assets into marketable securities that can be sold to investors. The process leads to the creation of financial instruments that represent ownership interest in, or are secured by a segregated income producing asset or pool of assets. The pool of assets collateralises securities. These assets are generally secured by personal or real property (e.g. automobiles, real estate, or equipment loans), but in some cases are unsecured (e.g. credit card debt, consumer loans). There are four steps in a securitisation: (i) SPV is created to hold title to assets underlying securities; (ii) the originator or holder of assets sells the assets (existing or future) to the SPV; (iii) the SPV, with the help of an investment banker, issues securities which are distributed to investors; and (iv) the SPV pays the originator for the assets with the proceeds from the sale of securities. The touchstones of securitisation are:

- Legal true sale of assets to an SPV with narrowly defined purposes and activities
- Issuance of securities by the SPV to the investors collateralised by the underlying assets
- Reliance by the investors on the performance of the assets for repayment - rather than the credit of their Originator (the seller) or the issuer (the SPV)
- Consequent to the above, "Bankruptcy Remoteness" from the Originator

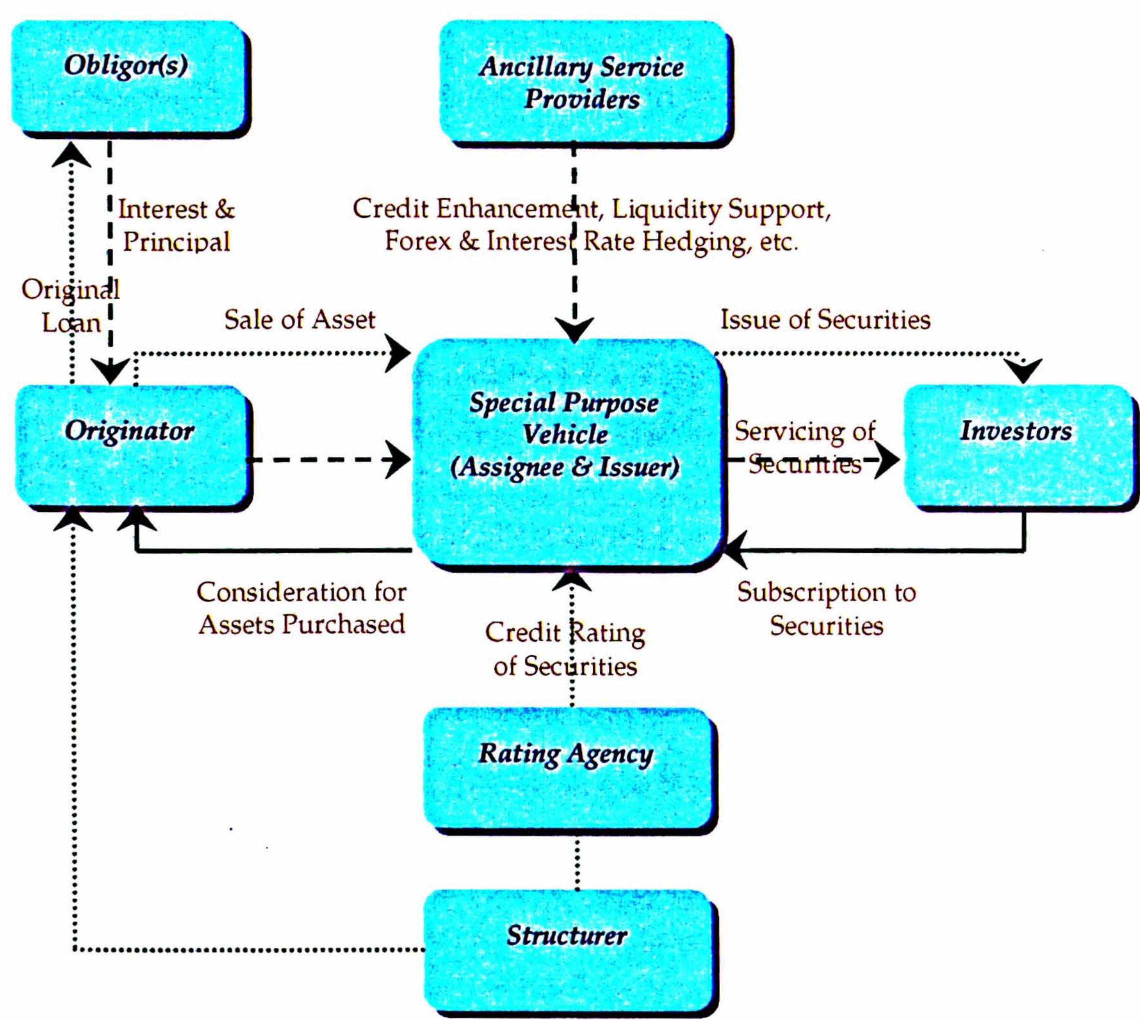
Apart from the above, the following additional characteristics are generally noticed:

- administration of the assets, including continuation of relationships with obligors
- support for timely interest and principal repayments in the form of suitable credit enhancements
- ancillary facilities to cover interest rate / forex risks, guarantee, etc.
- formal rating from one or more rating agencies

A securitisation transaction generally involves some or all of the following parties: (i) the initial owner of the asset (the originator or sponsor) who has a loan agreement with the borrowers (obligors); (ii) the issuer of debt instruments who also is the SPV. The structure keeps the SPV away from bankruptcy of the originator, technically called 'bankruptcy remote'; (iii) the investment bankers who assist in structuring the transaction and who underwrite or place the securities for a fee; (iv) the rating agencies, who assess credit quality

of certain types of instruments and assign a credit rating; (v) the credit enhancer, possibly a bank, surety company, or insurer, who provides credit support through a letter of credit, guarantee, or other assurance; (vi) the servicer, usually the originator, who collects payments due on the underlying assets and, after retaining a servicing fee, pays them over to the security holders; (vii) the trustee, who deals with issuer, credit enhancer and servicer on behalf of the security holders; (viii) the legal counsel, who participates in the structuring of the transaction[1]; and (ix) the swap counterparty who provides interest rate / currency swap, if needed. A typical securitisation structure is given below.

Figure 1 Typical Securitisation Structure



Note: Continuing flow of funds from the Obligor to the SPV is routed through the Originator in its capacity as administrator. Any other party appointed by the SPV/Trustee can also perform the role of administrator. It is also possible that the SPV receives the amounts directly from the Obligors.

[1] Shenker Joseph C and Colletta Anthony J., 'Asset Securitisation Evolution: Current Issues and New Frontiers'.In *Texas Law Review,* 69:1369 (1991) p.1374

2.2 Parties to a Securitisation Transaction

There are primarily three parties to a securitisation deal, namely -

a. The Originator: This is the entity on whose books the assets to be securitised exist. It is the prime mover of the deal i.e. it sets up the necessary structures to execute the deal. It sells the assets on its books and receives the funds generated from such sale. In a true sale, the Originator transfers both the legal and the beneficial interest in the assets to the SPV.

b. The SPV: The issuer also known as the SPV is the entity, which would typically buy the assets (to be securitised) from the Originator. The SPV is typically a low-capitalised entity with narrowly defined purposes and activities, and usually has independent trustees/directors. As one of the main objectives of securitisation is to remove the assets from the balance sheet of the Originator, the SPV plays a very important role inas much as it holds the assets in its books and makes the upfront payment for them to the Originator.

c. The Investors: The investors may be in the form of individuals or institutional investors like FIs, mutual funds, provident funds, pension funds, insurance companies, etc. They buy a participating interest in the total pool of receivables and receive their payment in the form of interest and principal as per agreed pattern.

Besides these three primary parties, the other parties involved in a securitisation deal are given below:

a) The Obligor(s): The Obligor is the Originator's debtor (borrower of the original loan). The amount outstanding from the Obligor is the asset that is transferred to the SPV. The credit standing of the Obligor(s) is of paramount importance in a securitisation transaction.

b) The Rating Agency: Since the investors take on the risk of the asset pool rather than the Originator, an external credit rating plays an important role. The rating process would assess the strength of the cash flow and the mechanism designed to ensure full and timely payment by the process of selection of loans of appropriate credit quality, the extent of credit and liquidity support provided and the strength of the legal framework.

c) Administrator or Servicer: It collects the payment due from the Obligor/s and passes it to the SPV, follows up with delinquent borrowers and pursues legal remedies available against the defaulting borrowers. Since it receives the instalments and pays it to the SPV, it is also called the Receiving and Paying Agent.

d) Agent and Trustee: It accepts the responsibility for overseeing that all the parties to the securitisation deal perform in accordance with the securitisation trust agreement. Basically, it is appointed to look after the interest of the investors.

e) Structurer: Normally, an investment banker is responsible as structurer for bringing together the Originator, credit enhancer/s, the investors and other partners to a securitisation deal. It also works with the Originator and helps in structuring deals.

The different parties to a securitisation deal have very different roles to play. In fact, firms specialise in those areas in which they enjoy competitive advantage. The entire process is broken up into separate parts with different parties specialising in origination of loans, raising funds from the capital markets, servicing of loans etc. It is this kind of segmentation of market roles that introduces several efficiencies securitisation is so often credited with.

More details of various agencies are given in Chapter 8.

2.3 Pass and Pay Through Structures

The nature of the investors' interest in the underlying assets determines whether a securitisation structure is a 'Pass Through' or 'Pay Through' structure. In a pass through structure, the SPV issues 'Pass Through Certificates' which are in the nature of participation certificates that enable the investors to take a direct exposure on the performance of the securitised assets. Pay through, on the other hand, gives investors only a charge against the securitised assets, while the assets themselves are owned by the SPV. The SPV issues regular secured debt instruments. The term PTCs has been used in the report referring to pass through as well as pay through certificates.

Pay through structures permit de-synchronization of servicing of the securities from the underlying cash flows. In the pay through structure, the SPV is given discretion (albeit to a limited extent) to re-invest short term surpluses - a power that is not available to the SPV in the case of the pass through structure. In the pass through structure, investors are serviced as and when cash is actually generated by the underlying assets. Delay in cash flows is of course shielded to the extent of credit enhancement. Prepayments are, however, passed on to the investors who then have to tackle re-investment risk. A further advantage of the pay through structure is that different issues of securities can be ranked and hence priced differentially.

2.4 Asset and Mortgage Backed Securities

Securities issued by the SPV in a securitisation transaction are referred to as Asset Backed Securities (ABS) because investors rely on the performance of the assets that collateralise the securities. They do not take an exposure either on the previous owner of the assets (the Originator), or the entity issuing the securities (the SPV). Clearly, classifying securities as 'asset-backed' seeks to differentiate them from regular securities, which are the liabilities of the entity issuing them.

In practice, a further category is identified – securities backed by mortgage loans (loans secured by specified real estate property, wherein the lender has the right to sell the property, if the borrower defaults). Such securities are called Mortgage Backed Securities (MBS). The most common example of MBS is securities backed by mortgage housing loans. All securitised instruments are either MBS or ABS.

2.5 Credit Enhancement

Investors in securitised instruments take a direct exposure on the performance of the underlying collateral and have limited or no recourse to the Originator. They hence seek additional comfort in the form of credit enhancement, a term used to describe any of the various methods by which risks intrinsic to the transaction are re-allocated. Put simply, it refers to any of the various means that attempt to buffer investors against losses on the assets collateralising their investment. These losses may vary in frequency, severity and timing, and depend on the asset characteristics, how they are originated and how they are administered. Credit enhancements are often essential to secure a high level of credit rating and for low cost funding.

By shifting the credit risk from a less-well-known borrower to a well-known, strong, and large credit enhancer, credit enhancement corrects imbalance of information between lender and borrower. Credit enhancements are either external (third party) or internal (structural or cash-flow-driven). Various kinds of credit enhancements are elaborated below:

i) External Credit Enhancements

Insurance: Full insurance is provided against losses on the assets. This tantamounts to a 100 per cent guarantee of a transaction's principal and interest payments. The issuer of the insurance looks to an initial premium or other support to cover credit losses.

Third party guarantee: This method involves a limited/full guarantee by a third party to cover losses that may arise on non-performance of the collateral.

Letter of credit: For structures with credit ratings below the level sought for the issue, a third party provides a letter of credit for a nominal amount. This may provide either full or partial cover of the issuer's obligation.

ii) Internal Credit Enhancements

Credit Tranching (senior/sub-ordinate structure): The SPV issues two (or more) tranches of securities and establishes a pre-determined priority in their servicing, whereby first losses are borne by the holders of the sub-ordinate tranches (at times the Originator itself). Apart from

providing comfort to holders of senior debt, credit tranching also permits targeting investors with specific risk-return preferences.

Over-collateralisation: The Originator sets aside assets in excess of the collateral required to be assigned to the SPV. Cash flows from these assets must first meet any overdue payments in the main pool, before they can be routed back to the Originator.

Cash collateral: This works in much the same way as the over-collateralisation. But since the quality of cash is self-evidently higher and more stable than the quality of assets yet to be turned into cash, the quantum of cash required to meet the desired rating would be lower than asset over-collateral to that extent.

Spread account: The difference between the yield on the assets and yield to the investors from the securities is called excess spread. In its simplest form, a spread account traps the excess spread (net of all running costs of securitisation) within the SPV up to a specified amount sufficient to satisfy a given rating or credit quality requirement. Only realisations in excess of this specified amount are routed back to the Originator. This amount is returned to the Originator after the payment of principal and interest to the investors.

Triggered amortisation: This works only in structures that permit substitution (for example, rapidly revolving assets such as credit cards). When certain pre-set levels of collateral performance are breached, all further collections are applied to repay the funding. Once amortisation is triggered, substitution is stopped and the early repayment is an irreversible process. Triggered amortisation is typically applied in future flow securitisation.

2.6 Future Flow Securitisation

2.6.1 Introduction

A future receivable securitisation, as the term implies, raises funds based on expected future cash flows that have not, at the close of the transaction, been generated[2]. These types of transactions can be split into two distinct areas: long term contract receivables and future cash flows. Examples of long term contract receivables would be term off-take agreements for the supply of goods or services such as the export of commodities (e.g. oil, coffee or steel) or payment for clearing services. In this category the volume of the receivables will be known or at least be set at a minimum. However, the price of the receivables may be variable. To the extent that the receivables are generated from the sale of commodity /product there may be an opportunity to provide some type of price floor through the use of

[2] International Securitisation – ABN Amro May 1998.

hedging instruments. The future cash flow category would include receivables that are not only subject to price variations but also to variations in volume (i.e., there is no minimum contracted volume). These would include telecom receivables, ticket receivables and worker remittance payments. All these categories will have no minimum volumes over the life of the issue but will depend on both the performance of the seller and macro-economic events. In these cases the rating agencies will assume a base case for the volume of receivables over the life of the transaction. This will then be subjected to stressing either by applying an over-collaterisation multiple or by reducing the base case cash flows progressively over a number of years. This cash flow is then assigned as collateral for the repayment of debt instruments sold in the capital markets. The nature of that cash flow, taken together with a string of other structural credit enhancements, generally ensures that the transaction is rated above the unsecured debt ratings of the borrower. As a result, under a securitisation transaction, the borrower is able to achieve finer pricing and/or longer tenors than is otherwise available from other funding sources.

2.6.2 Asset Classes Securitised

ABSs have been constructed based on future income streams that arise from the use of physical assets (e.g. telecommunication network, toll charges on roadways), income arising due to regulations (e.g. revenue taxes of municipal authorities), income from sale of natural resources (e.g. oil and natural gas), etc. Historically, five types of asset classes have generated the bulk of future flow securitisation. These are:

i) Exports of commodities or commodity-like products
ii) Credit card receivables (generated from the use of Visa and MasterCard credit cards by tourists in the host country)
iii) Telephone toll receivables arising from international traffic service
iv) Workers' remittances; and
v) Project finance based transactions.

With respect to export securitisation, transactions have been concluded for Oil, Gas, Copper, Aluminum, Steel, Pulp, Energy, Gold, Silver, Diamonds, Orange juice, Soybean, Wheat, even Fish etc. Less important classes include airline ticket sales, airport landing fees and the export of semi-finished goods.

2.6.3 Motives for Future Flow Securitisation

(a) Cost of Funds: The most convincing argument to borrowers as to why to engage in future flow securitisation remains cost of funds. Most future flow securitisation achieves significantly higher ratings than unsecured "vanilla" corporate debt. This rating improvement usually results in lower spreads to the borrower. The exact benefit, however, can be sometimes difficult to demonstrate. This is because, in many cases, the borrower does not or cannot issue long dated corporate bonds.

(b) Diversification of Funding Sources: Just as important as reducing cost of funds is diversifying access to funding sources. Many borrowers in the emerging markets (EMs) rely heavily on either bank financing or unsecured bonds. Yet, in times of financial crises, these funding sources can quickly dry up. The perceived higher quality of the securitised transactions ensures that investor demand will continue for the paper, even in time of great stress. A good example of this is the Mexican Peso crisis of 1994. Notwithstanding the liquidity crisis in Mexico, and the tremendous stress that the financial sector underwent, Mexican banks were able to access seven-year money based on securitisation of their Visa and Master Card receipts.

(c) Longer Tenure: Securitisation can serve to extend the tenure of financing available to borrowers. Depending on the asset class, tenures of up to 30 years can be achieved. Longer dated transactions are generally available for securitisation supported by oil, gas or minerals.

(d) Limited Recourse: Many securitisations are structured as a sale to investors of future receivables. The recourse to the borrower in the event that such receivables are not generated or collected, or the product is not delivered can be limited. Both investors and rating agencies assess the strength of the transaction, taking into account such risks. Given that in many instances the future assets or cash flow being securitised is the highest quality of assets that a borrower may have, general recourse is not considered to enhance the transaction from a credit perspective. Instances where recourse will, however, be required include non-performance by the borrowers of their obligations (or covenants) under the transaction, a loss of the rights of the investors in the asset and bankruptcy proceedings.

2.6.4 Risks

(a) Bankruptcy / Performance Risk: Since future flow transactions rely on the future generation of cash flow to repay investors, the continued existence and performance of the borrower throughout the tenure of the transaction are critical considerations to investors.

Indeed, this risk generally acts as the limiting constraint on the rating of the transaction and consequently determines the tenure as well as the pricing.

The ultimate rating may be enhanced by at most one notch above the local currency rating of the borrower in case the securitisation constitutes a true sale transaction under the bankruptcy laws of the borrower. In other words, should the borrower become insolvent, no creditors of the borrower would be able to make a claim against the receivables sold to investors. So long as the borrower continues to operate (even in bankruptcy), investors will receive payments on the receivables on time and unhindered. In terms of mitigating this risk, there is very little that can be done structurally without obtaining the support or guarantee of a rated third party.

(b) Generation Risk: There still is another risk related to the sustained generation of the receivables at certain levels from a host of factors outside of the control of the borrower, e.g. anticipated reserves may not materialise or seasonal variations in the anticipated levels of receivables may occur. This risk is mitigated through adequate over-collateralisation. Further, in order to protect investors against more sustained long-term declines in the levels of receivables generated, early amortisation triggers are usually built into the transaction that will trigger the repayment of the securities on an accelerated basis if a predefined trigger level is breached.

(c) Price Risk and Off-take Risk: These refer to likely price variations or the concern that the Obligors in the future cease buying or reduce their purchasing level of the goods or service from the seller.

2.6.5 Other Considerations

(a) True Sale: There are some questions related to whether sale of receivables yet to be generated is legal, valid and binding and cannot be disrupted by a liquidator of the seller in bankruptcy. In many jurisdictions including the US, such sales are not enforceable. However, many other jurisdictions, such as Mexico, Brazil or Turkey do allow for such a true sale of future receivables. In India too, at present, it is difficult to perfect the security interest in respect of future receivables for the benefit of the investors and ultimately transactions may have to be structured with some recourse to the Originator in events of default.

(b) Negative Pledges: Investors cannot have a general recourse to the seller for all events leading to a shortage in cashflow from the receivables. They may only have recourse in situations that were under the control of the seller (such as failing to produce the goods or

services in sufficient volumes). Events deemed outside the control of the seller are price risk, liquidity risk and credit risk. These risks can be mitigated somewhat by the techniques discussed above but ultimately, they must lie with the investors in all securitisation transactions whether of existing receivables or of future flows.

(c) Accounting Treatment: Though a future flow securitisation may not always be treated as debt for regulatory, negative pledge or tax purposes, it almost always has to appear as a liability on the balance sheet of the seller. This is because the seller is selling "future" assets that were not on the balance sheet on the closing date of the transaction. The seller will receive the principal amount of the transaction as cash, and a corresponding entry has to be made on the liability side of the balance sheet that reflects the seller's obligations to deliver future goods or services to the SPV.

2.6.6 Indian context

According to one view, future flow receivables of export / petroleum / oil exploration etc. are not considered suitable for securitisation at present in India for the following reasons:

- It is a relatively recent phenomenon even in the international market and is fraught with risks, which revolve around the definition; ascertainability and quantifiability of securitisable cash flows. Such risks may not be well understood by investors. FIs need to develop the required competence in analysis of such risks before getting themselves exposed.
- Repayment to investors out of future sales could erode the current assets hypothecated to working capital bankers or the capacity of the Originators to service term loans / meet other pressing obligations.

Therefore, extreme caution is called for when the financial institutions book assets based on future cash flow or they guarantee the repayment of the underlying obligations. However, there is huge potential for securitising future receivables in infrastructure sector in India as detailed in Chapter 4.

Chapter 3 Securitisation – Motivation and Benefits

3.1 General

3.1.1 In general, innovation in financial products and services can improve economic performance by (i) meeting demands for completing the markets with expanded opportunities for risk sharing and risk pooling. Completing the markets refers to the class of securities being expanded by securities that provide access to risk-return combinations that previously were not available to investors; (ii) lowering transaction costs or increasing liquidity; (iii) reducing agency costs caused by asymmetric information and costly and incomplete monitoring[3].

3.1.2 Securitisation in the past has enabled banks and thrifts to cope with disintermediation (disappearance of low cost, fixed rate deposits and high quality, higher yielding loans) by reshaping their intermediary role and turning them from spread banking to conduit banking, deriving their income from originating and servicing loans ultimately funded by third parties. The requirements for capital adequacy in recent years have also motivated the FIs to securitise. Further, lack of access to outside capital especially in current macro-economic scenario when credit rating for many developing countries has been downgraded, is another major motivating factor. On demand side, investors viewed securities issued in securitised transactions as having desirable risk characteristics and greater spread over US Treasury obligations (a benchmark rate) than securities of comparable risk.

3.1.3 Globalisation, deregulation of financial markets and the surge in cross border activities have increased competition among financial institutions and have created opportunities for financial engineering. Securitisation increases lending capacity without having to find additional deposits or capital infusion. The FI gets more visible to the outside world and investors through the process of securitisation. The process of origination, underwriting, loss recovery, servicing etc. start getting attention of investors, rating agencies and other outside parties. This leads to self-examination and careful business decisions. Securitisation facilitates specialisation as has been seen in US securities market. Loan originations are often geared to meet another institution's underwriting standards. Loan servicing may be provided

[3] Merton Robert, 'Financial Innovation and the Financial System', In: *Cases in Financial Engineering*, Mason, Merton, Perold, and Tufano (1995) p. 8.

by a third institution, and assets may be sold to yet another party (SPV). For bad debts, an outside service agency's services may be taken. A liquidator may dispose off assets. Once these functions are separable, costs and efficiencies become transparent. FIs retain those functions / services that have perfect fit with core competence or operational advantage of the organisation.

3.1.4 FIs should look to securitisation as an opportunity. First, they can maximise their distribution capacity and raise their turnover of assets rather than the volumes of assets. The result can be a series of fee income rather than one interest spread. Second opportunity is to increase shareholders value substantially. By unbundling the balance sheet and selling off assets, FIs will be left overcapitalised. An obvious solution is to repurchase equity (if covenants permit) and enhance ROE substantially. Primary dealers in Government securities market, whose stock in trade are Government securities, can unbundle the interest coupons and securitise the same. The main advantages are in the form of capital relief, capital allocation efficiency, and improvement in financial ratios, etc.

Balance Sheet Effects:

3.2 Capital relief

FIs as Originators are required to maintain minimum capital to risk-weighted assets ratios (CRAR). In a true securitisation process assets are taken off the balance sheet of the Originator. To that extent, CRAR is not required to be maintained. Other Originators may be restricted by their indenture covenants or by regulators from securing debt beyond a specified level. Securitisation reduces the total cost of financing by giving capital relief. The cost of capital coverage (CCC) for the assets in question is eliminated since the assets are removed from the balance sheet. This cost represents the incremental additional cost of equity over the cost of 100% debt financing. We assume that the FI is not over-capitalised and any funding of assets by traditional balance sheet finance requires the Originator to maintain the proportion of debt and equity constant before and after the financing. In other words, CCC is the weighted average cost of capital (WACC) minus cost of debt.

Securitisation reduces the cost of capital in the following way:

a. investors benefit from access to markets where previously this was not possible

b. liquidity lowering the required rate of return

3.3 Capital planning

Capital to total assets can be increased either by (i) raising tier I capital or (ii) raising tier II capital or (iii) securitisation. If Tier I capital is issued, share prices may go down. There are

limits for issuing tier II capital. In the case of securitisation, banks may provide funds for Cash Collateral Account to meet loan losses out of capital as a method of internal credit enhancement. They may have two options:

Option I

Two tranches: AAA at 16 BP over LIBOR and A at 40 BP above LIBOR
Loan loss: 2%

Option II

Three tranches: AAA at 16 BP, A at 40 BP and BBB at 80 BP above LIBOR.
Loan loss: 1%.

Second option is more expensive in debt term, but cheaper in equity terms.

3.4 Capital requirement

Banks and other financial service institutions ("regulated institutions") are required to maintain certain minimum capital-to-riskweighted-assets ratios pursuant to the Basle Committee guidelines applicable to them. Basle guidelines on capital requirements may probably cause the FIs in western countries to consider: (i) decrease commercial, credit card, auto loans with 100% risk weightage (there is more incentive for these assets than the mortgage loans with 50% weightage) and securitise them; (ii) invest the funds thus generated in lower-weighted Treasuries (0 percent weight) or agencies (20 percent).

Securitisation leads to capital relief, which in turn improves leverage. The improvement in leverage can improve the Return on Equity (ROE) of a company as is illustrated below[4].

Table 1: Capital Requirement

Comparison between two banks #1 and #2

Leverage = Assets/ Equity

Total assets of bank #1 and #2 are $30 each.

Net Interest Margin or return on assets (ROA) = 1% or 0.30

US$

Bank # 1 Equity=1.00		Bank # 2 Equity=0.25	
Leverage ROE	30/1=30 0.30/1.00=30%	Leverage ROE	30/0.25=120 0.30/0.25=120%

[4] Thibeault Andre E., Chairman, Nijenrode Centre for Finance, Nijenrode University, Reader for the course '*Management of Financial Institutions*' (1997-98), p. 114

Implication:

The higher the leverages, the higher the ROE even with the same ROA (1% in the above case).

There is limitation beyond which it is not prudent for banks to increase the leverage. In the above illustration, suppose the local bank Regulators impose the loan loss provision requirement of say average 2% of total assets or 0.60, which has to be provided from capital, then Bank #1 will survive, but Bank #2 will have negative capital of 0.35.

3.5 Income Statement Effect

Securitisation can have the following income-related effects:

Recognising profits

When the assets held in investment account (as against the trading account) are sold consequent upon a fall in market interest rates, profits are recognised. If these assets were not securitised, the same would continue to be shown at the book value till maturity or till they are sold.

Changing the timing of income

Securitisation helps in adjusting the receipt of cash flows as per the needs of the interested party. The sequential tranches can help deferring the receipt of principal to a later date by a particular party, which can help in tax planning. The cash flows can be compared to rain storms and water pipes delivering water to a city. The benefits of any fixed volume of water are determined as much by how it is controlled as by its sheer volume. Securitisation is like a water works system for cash flows. It allows effective direction and control of flows to specific purposes. The structure delivers the proper flows in the right quantities at the right timings to meet these objectives.

Raising funds at cheaper rates

Improvement in credit rating reduces the fund raising.

One time fee income:

Income may be improved because the institution can charge one-time fee for processing loans and also can serve as administrator for those loans, which are securitised. This improves return on assets (ROA).

3.6 Influence on financial ratios

As illustrated below, cash generated through securitisation has different repercussions on the balance sheet, depending upon the strategy of the company for its capital structure and its

RBI LIBRARY RBI

appetite for increasing or decreasing leverage. In the following illustration, the impact of securitisation on the financial ratios of bank XYZ is given.

Table 2: Financial ratios

Assumptions: (i) Receivables for auto loans are sold at par; & (ii) Loan to Value ratio is 100%

Original B/S (US $)

Assets		Liabilities	
Receivables for auto loans	100	Debt	100
Consumer loans	100	Equity	100

Debt: Equity ratio = 1:1

Scenario I

When XYZ borrows 100 (not "true sale"), secured by its receivables for auto loans, the B/S will undergo change as under:

Assets		Liabilities	
Cash	100	Debt	200
Receivables for auto loans	100	Equity	100
Consumer loans	100		

Result:

- debt equity ratio worsens to 2:1
- debt equity ratio remains same if 100 realised is used to pay old debt

Scenario II

When receivables for auto loans are sold ('True sale')

Assets		Liabilities	
Cash	100	Debt	100
Consumer loans	100	Equity	100

Result:

- debt equity ratio is unchanged at 1:1
- B/S size is unchanged

Scenario III

In Scenario II, when major part of the fresh cash received is utilised to pay off debt

Assets		Liabilities	
Cash	10	Debt	10
Consumer loans	100	Equity	100

Result:

- debt equity ratio improves dramatically
- B/S size is reduced

Other Benefits

3.7 Providing Market Access

Borrowers are able to have access to markets in a better way through securitisation: (i) non-investment grade institutions in EMs can fund themselves at investment grade pricing; (ii) assets backing a security paper are subjected to stress by the rating agencies to arrive at the level of credit enhancement required, providing added comfort to the investor. This improves the access of the FIs to a wide range of investors; (iii) the improved rating can help FIs in EMs to get capital for longer tenure than normally available; and (iv) low rated Originators can have access to cheaper funds with enhanced rating which may include *piercing of the sovereign ceiling* of rating in certain cases. A sovereign's rating on its foreign currency obligations is normally regarded as a ceiling on ratings for other issuers domiciled in the country. Sovereign default could force all other domestic issuers to default as a mean of avoiding own default. However, securitisation through structuring of a particular set of assets and various credit enhancement devices may be able to pierce through this sovereign ceiling. Historical evidence suggests that sovereign foreign currency defaults don't always lead to defaults in private sector. When New York City defaulted in the 1970s, companies from the Big Apple did not. Factors like the strategic importance of an FI to the country may persuade Government to allow certain issuers to continue servicing their debt even when rigorous exchange controls are in place. Geographical diversification, international affiliations, and support agreements may accord some institutions to perform better than the sovereign may.

3.8 Overcoming constraints of Market Segmentation

A market segment is an identifiable group of investors (or purchasers) who purchase a product with particular attributes that are distinct from the attributes of alternative investments. Investors who prefer a firm with a particular capital structure strictly because of their own risk preference are able to avoid transaction costs of personal leverage by simply investing in a firm that already has their preferred amount of leverage[5]. Different tranches in securitisation overcome constraints of market segmentation. Securitisation reallocates risks to the segment of the market most willing and able to manage them, such as by obtaining a surety bond, letter of credit, or dividing the securities issued into a larger senior class, which is sold at a lower yield than could be achieved without segmenting the asset's risk, and a smaller subordinated class, which is either retained by the seller, or sold at a higher yield than

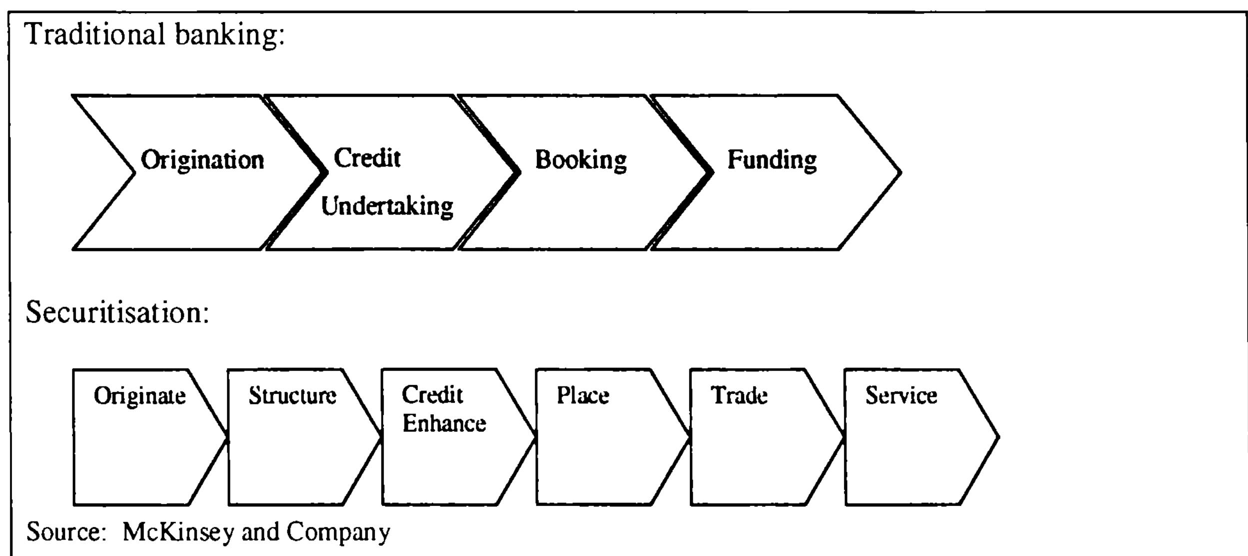
[5] Emery, Douglas R.; Finnerty, John D. *Corporate Financial Management*. New Jersey : Prentice Hall, 1997, p.482.

the senior class. Unlike the conventional capital markets, securitisation allows borrowers of all sizes and credits to access capital markets and thus remove the constraints of market segmentation. Investors, who are not bankers, can't originate loans and can't get exposed to loans. For example, an insurance company normally invests only in bonds, treasury bills etc. Securitisation helps it to invest in ABSs backed by commercial loans, an opportunity, which was never available earlier. Similarly, other segments of market are able to have access to a variety of instruments: investors having tolerance for interest rate risk can get long term paper, those who want to match short term liabilities can pick up short-term paper. Sequential issues meet the appetite of other types of investors.

3.9 Strategic tool

Securitisation benefits the FIs in different ways by: (i) providing strategic choices; (ii) reducing funding costs; (iii) developing core competencies in certain areas. For example, some institutions specialise in originating and servicing, not financing at all. Other institutions expand business volume without expanding their capital base in the same proportion. The process helps in identifying cost pools of various activities in the value chain. As can be seen from Figure 2, securitisation is changing the horizons of traditional banking significantly:

Figure[6] 2: Traditional banking and Securitisation



Source: McKinsey and Company

[6] Rosenthal James A. ; Ocampo Juan M, 'Securitisation of Credit', NewYork John Wiley & Sons, Inc. p. 14

Many new lines of business grow out of securitisation - insurance of assets, clearance services, custodial services and master servicing of securities etc. Depending upon the core competence and trade off between costs and benefits, institutions may like to retain or divest of some of these activities. Institutions may develop competitive advantage through more efficient marketing, tighter credit monitoring, lower cost servicing, higher volumes (automobiles, credit cards etc.) and other ways to outperform competitors.

3.10 Liquidity

(i) Fund raising through securitisation is independent of the Originator's rating. The market for securities is more efficient than for bulk asset sales as the latter is illiquid. Many banks are trapped in a situation where they can't rollover their debt due to downgrading of the ratings of the issuer below investment grade consequent upon the changes in economic environment. This happens when long term assets are being financed by short-term liabilities (CP. etc.) which are rolled-over from time to time. Securitisation enables FIs to increase the rating of debt much higher than that of the issuer through intrinsic credit of the assets themselves. This enables the FIs to obtain funding which was not feasible earlier. The funds raised by some of the banks[5] in EMs are examples in the point.

(ii) The liquidity provided by securitisation makes it an extremely powerful tool, which can be used by management to adjust asset mix quickly and efficiently. The risks in an asset portfolio can be divided and apportioned so that some risks are transferred while others are retained.

(iii) Liquidity is also increased through fractionalised interest that is marketable to a broader range of suppliers of capital.

3.11 Risk Tranching / Unbundling

(i) A securitised transaction is structured to reallocate certain risks inherent in the underlying assets such as prepayment risk and concentration risk. With reduced or reallocated risks and greater liquidity, securities are more appealing to a wider range of purchasers (conform the market segmentation theory as explained in para 3.8) and, consequently, the yield required to sell them will be lower.

(ii) Securitisation can modify the risk exposure of investors to various risks by creating securities that allocate these risks according to specific rules. The institution can then sell the securities, which have risk characteristics not suitable to the organisation and keep those

[5] Allen, Craig M. and Thomas Annie, Aegis Financial Advisors, Inc., NewYork In. 'Securitisation of assets: a corporate strategy and its implications'

with risk profile matching the overall mission of the organisation. An example is the practice of subordinating one tranche of a security to another for credit enhancement. A security may be divided into two tranches, A class and B class, the former giving lower yields but having priority over claims than B class security.

(iii) Investors in ABSs have typically no recourse against the issuers. In a perfect securitisation process, true sale is involved and issuers can use SPVs to transfer, for instance, interest rate risk and credit risk to investors. Securitisation can help FIs manage interest rate risk in two ways. While variable rate loans and sale of loan participations enable a lender to share interest rate risk with borrowers or other FIs, asset securitisation may, in certain cases, permit a lender to remove the asset from its portfolio altogether, thereby shortening the portfolio's average maturity, and eliminating all interest rate risk associated therewith. Moreover, as buyer of MBS and ABS, FIs can select securities with shorter weighted average lives to match their short-term deposits. Thus, banks and thrifts have been big purchasers of "fast pay" tranches. Credit risk is transferred to credit enhancers. Credit risk is transferred in full if the issuer does not retain an interest in the assets. It is transferred in part if an issuer invests in an SPV (which is normally not the case) or retains a subordinate interest in it.

3.12 Asset-Liability Management

Some FIs in the EMs are not in a position to raise long-term international borrowings due to various limitations including the size of the institution, the sovereign limitation, etc. Securitisation helps in improving the rating for particular deal much above the institution's rating and enables the institution to raise funds for a longer period. This facilitates in matching the tenure of the liabilities and the assets.

Securitisation allows flexibility in structuring the timing of cash flows to each security tranche. In general, securitisation provides a means whereby custom or tailor made securities can be created. For example, a typical security issuer might wish to shorten the duration of a portfolio of mortgage loans. The liabilities against which mortgage loans are funded may have shorter duration than the assets. To minimise the gap mismatch, the issuer bank may create two classes of securities from mortgages – sequential pay securities i.e. the second security receives only interest until the principal and interest for the first security has completely been paid. The second security receives principal and interest only thereafter. Selling the second one and retaining the first one shortens the duration of its asset portfolio.

Securitisation also segments funding and interest rate risk so that it can be tailored and placed amongst appropriate investors. For example, in the mortgage area by virtue of relationship with their customers, banks and housing finance companies are best positioned to originate loans. Mortgage loans are usually for long tenures (between 15-20 years). Banks typically do not have access to such long tenure funds. On the other hand, investors such as pension funds and life insurance companies have long term funds, which require consistent yield. MBS thus enables the financial system to match the funding profile and thereby reduce aggregate risk in the financial system. The other risk in the mortgage finances is the incidence of early payment that arises as borrowers foreclose their loans due to various reasons. Creating multiple tranche from the common pool of receivables and thereby providing instruments, which have different types of early payment risks, can create structures of MBS to fine tune this risk. In addition, structures can be created using interest rate swaps etc. to ensure that the interest rate risks are passed on to natural counterparts.

3.13 Diversification of assets

Regulators in some countries have imposed ceilings for exposures of FIs to a single / Group of borrowers[6] as illustrated below.

India	25%/50% of capital and free reserves for banks for single /Group exposures
HK	2% of capital
Indonesia	20% of capital for groups of affiliated borrowers; 10% for a single person
Malaysia	30% of capital
Brazil	30% of net worth

The objective may be to reduce concentration of risk and also to make credit available to larger sections of society. Securitisation helps in the diversification of the loan portfolio beyond a few companies, geographical locations or even industries. FIs may take loans to certain customers off balance sheet in order to be able to lend new funds to those customers and still maintain the credit exposure limits.

3.14 Systems/Reporting

Securitisation provides the incentive to an FI to manage its loan portfolio better and keep better track of delinquencies and put more pressure on them to pay, in order to keep the cost

[6] The Economic Times, June 24, 1998

of future credit enhancement low. The portfolio has to be made more transparent to rating agencies and the investors. This permits easier mapping of internal risk codes with the external agency letter ratings needed to set pool risk ratings and enhancement levels. One important operational concern that new issuers of ABSs face is that of inadequate historical data on the assets and their performance. Data on loan payments etc. are many times not considered important for the ongoing maintenance of asset portfolió. These involve heavy costs for FIs in the EMs. The need to document the policies and procedures for originating, monitoring and servicing the assets to meet the requirements of the rating agencies helps FIs tone up their systems. The responsibility / accountability of FIs extends from equity holders to the investors of securitised bonds. MIS improves the transparency, uniformity and judicious decision making. Decisions can be identified and ongoing improvements in the quality of service can be undertaken. The benefits of accessing new markets (investors of securitised bonds) generally overweigh the additional administrative burden.

3.15 Originator Discipline

The discipline that securitisation provides not only in the treasury area of the seller but throughout all other aspects of business has an increasingly positive influence on an FI. Both the demands of adhering to strict underwriting criteria and compliance with the asset servicing covenants provide the seller with the necessary incentives with which to manage its business. Securitisation encourages best practices.

3.16 Client Relationship effect

The sale of loans as securities while retaining the customer contact through loan servicing gives the Originator access to deposits and other customer service opportunities. Ownership of customer remains with the servicer by virtue of billing and collection procedures; only ownership of the financial instruments is transferred to the new investors. Thus the servicer benefits from customer relation without the obligation to keep his loan on the balance sheet.

3.17 Pooling

Similar debt instruments can be pooled to enhance creditworthiness and transform illiquid loans into liquid market securities. MBSs, automobiles, credit cards are the examples. In the case of life insurance, by pooling a large number of similar people, uncertainty of a single person's default can be transformed into risk that can be priced, because objectively known probabilities can be attached to default. In the case of automobile loans, investors don't feel secure because they can repossess an automobile if a borrower defaults, but rather because, on average, these borrowers are unlikely to default beyond the level of credit enhancement.

Automobile loans are marketable because investors can place a good bet on the pooled characteristics of people who borrow to purchase autos. Once they are pooled, auto loans have a demonstrably low risk of default (lower than the mandated capital requirement). As it is inefficient to hold them on bank's balance sheets, the market will find ways to release some bank capital that is tied up because of regulations that insure risk that the market does not perceive. Grouping of financial assets (loans etc.) into homogeneous pool facilitates actuarial analysis of risks. It also makes it easier for third parties such as credit rating agencies and credit enhancers to review and reinforce the credit underwriting decisions taken by the original lenders. However, this has limited application for commercial loans. The costs of evaluating the pool to ensure that you are not buying a bunch of lemons and, relatedly, the lack of agency rating make such instruments less suitable for securitisation.

3.18 Other benefits to FIs

There are no reserve requirements, either in the form of cash reserve or statutory liquidity ratios for cash generated through securitisation by FIs as Originators.

3.19 Benefits to Customers

Investors purchase risk–adjusted cash flow streams. This is accomplished through tranching of loan pool into multiple certificates based on relative levels of seniority and maturity. An auto loan or credit card receivables backed paper carries regular monthly cash flows, which can match, for example, the requirements of mutual funds for expected monthly redemption outflows. Investors who would like to invest for long term capital gain purposes may not like to be burdened with periodical interest receipt and the reinvestment risk thereof. Such investors can also bundled their interest instrument through securitisation process.

3.20 Overall benefits to the Originators and the financial system

Securitisation benefits the originators in the following ways:

(a) The use of capital can be optimised by reconfiguring portfolios to satisfy the risk-weighted capital adequacy norms better.

(b) Properly structured securitisation transactions enable Originators to focus on growth of their franchise without the need to focus on growth of capital base. Competitive advantage to Originators will be built on efficient marketing, tighter credit management, lower cost of servicing rather than be based on the ability to raise capital. Cost and capabilities amongst competitors are no longer muted; rather they are highlighted and magnified.

(c) Securitisation directly rewards better credit quality by reducing cost of credit enhancement and the costs of funds. This serves as a clear incentive for institutions to improve the quality of loan origination. In short, Originators who ensure better credit quality are rewarded by securitisation.

(d) Securitisation gives weaker firms a way out without a downward spiral effect. A case in point is the recent NBFC sector performance. The focus on limiting access on public deposits by NBFCs, by regulator and by rating agencies, has pushed even established NBFCs out of businesses that they have run successfully for many decades. If focus had been placed in helping these institutions securitise their assets, their financials would have improved and lesser risks would have been retained on their balance sheets.

Apart from the specific benefits to the Originator, the financial system as a whole also stands to benefit from securitisation in the following ways:

- Securitisation breaks the process of lending and funding into several discrete steps leading to specialisation and economies of scale. This results in lower costs for the system as a whole and in the final analysis provides lower borrowing cost to the consumers. The most tangible result on account of the development of MBS market in United States is the reduction in the borrowing costs. MBS are priced at less than 100 basis points over similar tenure US Treasury[7]. A financial market that has wide variety of options to issuers and investors, coupled with lower costs, has an inherent bias for growth.
- The rate of asset turnover in the economy increases. For example, HFCs with excellent asset origination skills may have an insufficient balance sheet size to absorb the entire risk but can securitise loans in excess of what they feel comfortable with.
- As a direct consequence of the above, the volume of resources available increases substantially. This assumes significance in light of the fact that our economy as a whole, and specific sectors such as housing and infrastructure in particular, are capital starved. For example, mortgage securitisation provides a breakaway from the "specialist circuit" of housing finance into a broader pool of resources. Further, securitisation facilitates flow of funds from capital surplus to capital deficient regions.

[7] Citi Bank Mumbai

- Along with flow of funds across regions, even risk is redistributed from high default to low default regions. Securitised instruments reach wider markets, provide more suitable instruments and remain more resilient to market cycles than conventional debt.
- Component risks (credit, liquidity, interest rate, forex, and catastrophe) are segregated and distributed to market intermediaries equipped to absorb them most efficiently. This leads to a more stable financial system.
- The debt market as a whole attains greater depth. This fact has been borne out by the experience in other countries. The capital markets can participate more directly in infrastructure/other long gestation projects.

Securitisation provides a higher leverage than refinance or directed credit. For example, an Rs 100 crore lending through refinance by NHB allows an Rs 100 crore lending of mortgage loans or at best Rs 200 crore by the HFI (which receives the refinance). If NHB were instead to provide a 10% or 5% credit enhancement, the HFI would be able to do Rs 1000 to Rs 2000 crore of mortgage lending. This multiplier effect is critically required to ensure flow of funds to many critical sectors such as infrastructure, housing, exports, etc.

Securitisation results in standardisation of industry practices since investors and rating agencies will increasingly start demanding 'conforming' assets in order to find an instrument 'investible'. This improves predictability of performance of portfolios and thus predictability in the financial performance of the Originator

Linkage to capital markets brings depth and dampens "stress". Greater flow of funds into various sectors, which securitisation can help cause, will result in more stable sector performance.

3.21 Conclusion – EMs

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. Securitisation is gaining acceptance as one of the fastest growing and most innovative forms of asset financing in today's world capital markets. Many companies in EMs have already used securitisation as

part of their funding strategies. Some of the EM countries have, in fact, enacted a few legislations in quick succession to facilitate a better growth of securitisation market. The financial community, however, needs to be more aware of the benefits of the securitisation to help develop the market.

Chapter 4 Scope of Securitisation and Indian Experience

4.1 Introduction

The major players in the asset securitisation market in India are expected to be commercial FIs, PSUs, Corporates, Government bodies, Mutual Funds, Pension Funds, etc. Securitisation generally pre-supposes that the Originator has a bulk of its assets in the form of self-amortising financial assets, either with or without underlying security. It is also imperative that these assets should have a clearly established repayment schedule. Moreover, since capital market instruments have a minimum marketable tenure, the receivables underlying the securities should themselves have a sufficiently long tenure, so as not to frustrate the securitisation exercise.

While securitisation started off in the housing loan sector, the development of the securitisation market as a standard funding option across most industries has been the result of a constantly expanding universe of securitisable non-mortgage asset types. This chapter lays emphasis on three potential areas of securitisation in India - MBS, ABS and Infrastructure Sector.

4.2 Mortgage Backed Securities (MBS)

4.2.1 The securitisation of assets historically began with, and in sheer volume remains dominated by residential mortgages. The receivables are generally secured by way of mortgage over the property being financed, thereby enhancing the comfort for investors. This is because mortgaged property does not normally suffer erosion in its value like other physical assets through depreciation. Rather, it is more likely that real estate appreciates in value over time. Further,

- the receivables are medium to long-term, thus catering to the needs of different categories of investors;
- the receivables consist of a large number of individual homogenous loans that have been underwritten using standardised procedures. It is hence suitable for securitisation;
- in the US where it originated, these mortgages were also secured by guarantees from the Government;
- the receivables also satisfy investor preference for diversification of risk, as the geographical spread and diversity of receivable profile is very large.

More details are given in Para 6.1.

4.2.2 In the Indian context, the funds requirement in the housing sector is immense, estimated at Rs. 150,000 [8]crore during the current five-year plan. Of this, it is envisaged that about Rs 52,000 crore would be financed by the formal sector. It is unlikely that this gap can be filled out of budgetary allocation or regular bank credit. Securitisation allows this gap to be bridged by directly accessing the capital markets without intermediation. Securitisation tends to lower the cost at which the housing sector accesses funds. It also facilitates a sufficiently deep long term debt market. It is estimated that about Rs 2,500 crore would be mobilised through the securitisation route during the current five-year plan.

4.3 Asset Backed Securities (ABS) – Existing assets

(a) Auto loans:

Though securitisation was made popular by housing finance companies, it has found wide application in other areas of retail financing, particularly financing of cars and commercial vehicles. In India, the auto sector has been thrown open to international participation, greatly expanding the scope of the market. Auto loans (including instalment and hire purchase finance) broadly fulfil the features necessary in securitisation. The security in this case is also considered good, because of title over a utility asset. The development of a second hand market for cars in India has also meant that foreclosure is an effective tool in the hands of auto loan financiers in delinquent cases.

Originators are NBFCs and auto finance divisions of commercial banks.

(b) Investments:

Investments in long dated securities as also the periodical interest instruments on these securities can also be pooled and securitised. This is considered relevant particularly for Indian situation wherein the FIs are carrying huge portfolios in Government securities and other debt instruments, which are creating huge asset-liability mismatches for the institutions.

Government securities issued domestically in Indian Rupee can be bundled and used to back foreign currency denominated bonds issues. It would more be of the nature of derivative. The subordinated Government securities are intended to absorb depreciation in the value of the rupee thereby protecting to certain extent the senior securities that the Government securities back. The senior securities are directed at the international capital markets and are structured using offshore SPVs by countries like Mexico.

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[8] National Housing Bank

Similarly, under the STRIPs mechanism, the interest coupons on the Government dated securities are separated and traded in the secondary markets. Such interest instruments can also be bundled and securitised in the normal asset securitisation method.

(c) Others:

Financiers of consumer durable, Corporates whose deferred trade receivables are not funded by working capital finance, etc are Originators of other asset classes amenable to securitisation. Corporate loans, in a homogeneous pool of assets, are also subject to securitisation

There is virtually no known instance so far in the United States or in other countries of an ABS transaction having failed. This is despite the fact that the markets for ABS are exceptionally large. Industry experts attribute this to three main factors. ABS transactions are always planned, prepared and carried out with great care. Second reason is the intrinsic value of the paper and in particular the high level of transparency on the quality of the underlying assets. Third, ABS transactions are sponsored generally by large and well known institutions which can't afford to jeopardise their reputation with investors, the majority of which are institutional investors.

4.4 Securitisation of infrastructure receivables

4.4.1 Securitisation of wholesale assets refers mainly to the use of securitisation as a technique for infrastructure funding. The availability of an efficient infrastructure framework is vital to the economic growth and prosperity of any country. Traditionally, infrastructure facilities have been developed and provided by Governments and are looked upon as basic privileges of a citizen and have thus been accorded priority for Government investment. The Central Government has envisaged that more than 40% of the annual central plan outlay would be for the development of infrastructure.[9] In the context of India's size, population, and economic growth, the present infrastructure continues to be inadequate and will require massive incremental investment to sustain economic growth. Hence, the participation of private capital in the development of infrastructure (over and above the Government's direct involvement) is essential. The India Infrastructure Report submitted by the Rakesh Mohan Committee in 1995 estimated that a total outlay of Rs 400,000 – 450,000 crore would be required for infrastructure financing in the period of 1996-2001. Some of the broad

[9] Infrastructure Leasing and Financial Services (ILFS)

observations outlined in the report in respect of various infrastructure segments are detailed in the table hereunder.

Table 3: Criticality of Requirements and Outlay for Infrastructure

Segment	Criticality of Requirements – Status in 1995	Outlay estimated (Rs. crore)
Urban Infrastructure	Water Supply – Covering 20% of total population Toilet facilities covering 23.55% of households Sanitation – Covering 52% of households	94,000
Power	Peak Shortage of 19% and energy shortage of 8%. Addition of upto 111,500 MW from 1996-2006	500,000
Telecom	Penetration of 1.3 telephones for every 100 people	60,000
Roads	Of the total 165,000 km of highway (State and National) – 2% are four lane highways, 34% in the form of two lane highways and 64% single lane highways	95,000
Ports	Operating at optimal capacity utilisation and marred by lower efficiencies and delays because of using second and third generation equipment	25,000

4.4.2 Along with the Government's earnest attempt at attracting private investment into infrastructure funding, the role of innovative funding techniques such as securitisation is vital. The suitability of securitisation for infrastructure funding stems from the fact that cash flows are stable and concession driven, and also because ultimate credit risk (which is central to the concept of securitisation) is partly guaranteed by Government. Securitisation is particularly appropriate at the post-commissioning stage when the project begins to generate cash, with overall project risk being largely replaced by credit risk.

4.4.3 Some of the typical characteristics of infrastructure projects that set them apart from other financing needs are:

Multiple level project risks: Infrastructure financing involves risk participation at multiple levels and is complex to understand for individual investors. The nature of project risk in various stages is volatile, it is highest in the pre-commissioning stage and is sought to be

mitigated through contractual framework, which is concession driven or provides guaranteed returns. These guarantees and concessions are typically extended by Government and quasi Government organisations and thus minimise financial risk.

Unconventional asset cover: Infrastructure projects are typified by the creation of unconventional assets. The assets of an infrastructure project could comprise roads or bridges, jetties and quays in a port infrastructure project, drills and rigs pertaining to an oil well, water treatment plants. These assets are not amenable to resale or reapplication and hence are unacceptable as security cover to conventional lenders. Furthermore, the step-in rights to lenders are non-existent since such projects are awarded on the basis of concession and are on a Build Operate and Transfer (BOT) basis with the "ownership" of such assets resting with the State or Central Government.

4.4.4 Tenure and size of funds required: Infrastructure projects are typically long gestation projects involving high capital outlay and back-ended project returns. The sources of funds would hence have to be long term and provide for a sufficient moratorium.

4.4.5 Securitisation will benefit infrastructure financing because it:

- permits funding agencies whose sector exposures are choked, to continue funding to those sectors.
- permits the participation of a much larger number of investors by issue of marketable securities.
- lowers the cost of funding infrastructure projects; long term funding (a *sine quo non* for most infrastructure projects) is more feasible in securitised structures than conventional lending.
- facilitates risk participation amongst intermediaries that specialise in handling each of the component risks associated with infrastructure funding (while these may initially be borne by regular financial intermediaries and insurance companies, it is expected that specialised institutions would develop over time).
- shifts the focus of funding agencies to evaluation of credit risk of the transaction structure rather than overall project risk. This is because the other components of project risk (as mentioned above) would be borne by specialised intermediaries, at a fee.

4.4. 6 *Relevance of securitisation in some infrastructure sectors*

(a) Power

Various public sector units (PSUs) have a high financial exposure to state electricity boards (SEBs), some of which are sub-standard loans since several SEBs have inadequate solvency for meeting obligations on the due date. Securitisation in the power sector can be divided into the following segments:

- Receivables of PSUs such as National Thermal Power Corporation, Cola India Ltd., Power Finance Corporation, Rural Electrification Corporation, National Hydel Power Corporation, etc. from various SEBs can be securitised to reduce/rebalance financial exposure of these PSUs.
- Securitisation of SEB revenues for resource raising.

(b) Roads

Private sector road projects are expected to earn revenues from toll collections and concessions. However these projects carry multiple level of risks which could be summarised as under:

Construction risk – In event of inordinate delays in procuring land and completing implementation.

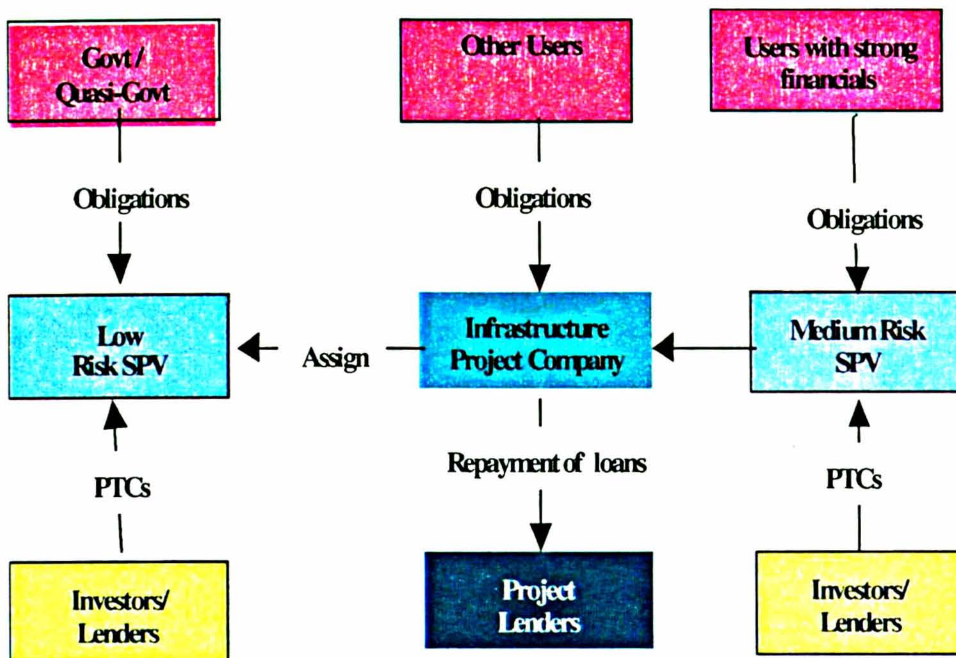
Traffic Estimation risk – Accuracy of estimating traffic in various segments i.e. commercial vehicles, buses, passenger cars, two wheelers and achieving desired traffic estimates

Toll collection risk – Intent and willingness of users to pay requisite tolls for usage.

Considering the multiple levels of risk, securitisation could be used to splice various levels of risks and thereby facilitate financial closure at an optimal cost of capital.

Following is an illustrative securitisation structure :

Figure 3 : Infrastructure Securitisation



In a typical road project, the Project Company could expect receivables from three broad categories of constituents. This could be classified under various "risk" categories as under:

i) Low Risk Users - Government/Quasi Government agencies which may have provided concessions or awarded the project on a BOT basis. The Government or its agency would guarantee a minimum toll/traffic or would provide concession in the form of a fixed return. The guarantee element would carry the same risk as that of the Government agency providing such assurance. Receivables from this nature could be securitised to low risk investors.

ii) Medium Risk Users - A road or a bridge to be constructed by the Project Company could be used in a large measure by industrial or corporate users, who would pay lump-sum tolls for usage of the road. The receivables from such entities could be securitised to users with a medium risk appetite.

iii) Other Users - A road would be used by passengers, one-time users and others. The toll receivables from small users would continue to be received by the Project Company.

(c) Ports

The revenues of typical port projects would be in the nature of stowage and loading revenues levied on ships, which stop at the port of call. In addition, ports tend to provide storage facilities for chemicals, cargo, petroleum products, etc. to several large companies. The port authority/operator contract such storage facilities for a long tenure. The port revenues of this nature are suitable to securitisation.

(d) Urban Infrastructure

Primarily, the opportunity in urban infrastructure is in the areas of housing loans (the same has been covered under the section pertaining to mortgage securitisation). The other areas under urban infrastructure are water supply, sewage facilities, garbage disposal, etc

4.4.7 Further, the above list is illustrative and not exhaustive. Wherever a reasonably certain sum of money will be received over a certain time, not very short, securitisation possibility exists. In short, the scope of securitisation is vast; ultimately being limited only by the consideration that assets proposed to be securitised must fundamentally be income bearing.

4.5 Future receivables:

4.5.1 Providers of utilities such as electricity and telephone services have an excellent opportunity of securitising electricity meter rentals and telephone rentals. The receivables in these cases are very widely spread, and delinquency record very favourable. A specific case can be that of VSNL. Being the sole gateway for inward traffic of international calls, the company gets a large and steady inflow of foreign exchange, that is ideal for securitisation.

Suggested accounting treatment for future flow receivables is given in Annexure – II (Para 15).

Export Receivables:

Securitisation of export receivables can be considered by (i) the financing FIs or (ii) exporters themselves. The basic requirement for securitisation would be that the receivables have a reasonable span of life so that they can be segregated and covered by a market instrument. The securitisation of export receivables over a medium to long term period could thus be securitised by any of the above entities. Among the Institutional lenders, EXIM Bank may be able to undertake securitisation since they are involved in financing exporters on deferred terms. Among the exporters, those engaged in export of capital goods may be able to do securitisation if the relevant mechanism is in place.

The export receivables are offshore dollar cash flow transactions as secured financing backed by future dollar receivables that can be isolated outside of India. In these transactions, the rights to receive future dollar cash flows can be transferred to an SPV outside India. The offshore vehicle issues the securities. As a result, the cash flows are first received outside India for payment to investors. Thus, it is possible to receive a rating on the securities higher than the India sovereign ceiling.

Because the primary goal in these transactions is to isolate the India sovereign risk, offshore dollar receivable transactions should be structured using special purpose vehicles outside of India. The securities that would be issued, moreover, would be dollar denominated and directed to investors outside of India. Consequently, these transactions are not affected by the legal issues in the Indian scenario. Such transactions are reported to have been done in Mexico. Exchange Control Department, RBI may examine the issue.

Forfeiture of concessional finance on exports:

Currently the RBI regulations state that export receivables must first be used to liquidate the packing credit facility or any other from of concessional export finance, if availed.

The concerned department/s of RBI may re-examine the issue keeping in view the international practice and the huge potential to securitise export receivables. RBI may consider issuing 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.

Credit card receivables:

Securitisation of credit card receivables is an innovation that has found wide acceptance. Although the average tenure of credit available to a credit card holder is generally very short (less than two months), it is revolving in nature. The lacuna of short tenor of the receivables is hence overcome by 'substitution', whereby collections are used for fresh purchases of receivables. Thus a securitisable asset of marketable tenure comes into being. The structure in this case is generally pay-through, since it is impossible to match the payment made by the cardholder with the payment to the investor.

Originators are credit card divisions/subsidiaries of commercial banks, including a number of foreign banks.

Airline ticket receivables:

Future sales of airline tickets can be securitised considering the predictability of the cashflows from the same.

Future oil sales:

Oil sales from confirmed oilfields can form a large pool of assets that are suitable for securitisation, especially considering that the Obligors would normally be high quality corporates

Lease rentals:

Equipment and real estate leases exhibit characteristics that are amenable to securitisation, particularly in respect of a fixed payment schedule for the lease rentals. In the Indian context, there is ample scope for securitisation of these future flows in this asset class in view of the impressive growth of hire purchase and leasing finance companies, especially after the issue of guidelines by the RBI regulating their functioning. While portfolios of lease/hire purchase receivables are obvious choices, securitisation can also be attempted for lease rentals from individual commercial properties, provided they are sufficiently big and backed by an agreement. Structuring securitisation transactions in this asset class would have to take into consideration the payment schedule of the underlying receivables, i.e. balloon, bullet, front-ended, back-ended and so on. Incorporation of international risks is necessary in the case of import leasing and cross-border leasing.

Originators are NBFCs and leasing divisions of commercial banks.

4.6 The Indian Experience

4.6.1 Securitisation is a relatively new concept in India but is gaining ground quite rapidly. CRISIL rated the first securitisation program in India in 1991 when Citibank securitised a pool from its auto loan portfolio and placed the paper with GIC Mutual Fund (a case study of one of Citibank's subsequent deals is discussed later in detail). Since then, securitisation of assets has begun to emerge as a clear option of fund raising by corporates and a few transactions of well-rated companies have taken place in the country. While some of the securitisation transactions which took place earlier involved sale of hire purchase or loan receivables of non-banking financial companies (NBFCs), arising out of auto-finance activity, many manufacturing companies and service industries are now increasingly looking towards securitising their deferred receivables and future flows also. Information on past deals is not readily available, as most of them have been bilateral one-to-one and unrated

transactions. In the context of rated transactions, CRISIL has rated about 50 transactions till date, with volume aggregating to well over Rs 4,500 crore. Other rating agencies in India, viz., ICRA, DCR and CARE have also been actively involved in the process. The majority of these being in the nature of outright sales of auto loan portfolios without subsequent issue of securities and do not amount to securitisation in the real sense. There has till date been no instance of downgrading of the rating assigned to any of these transactions. As per an estimate, out of the total asset securitisation attempted between 1992 and 1998, as much as 35 % relates to hire purchase receivables of truck and auto loan segment. The car loan segment of the auto loans market has been more successful than the commercial vehicle loan segment mainly because of factors such as perceived credit risk, higher volumes and homogeneous nature of receivables. Other types of receivables for which securitisation has been attempted include property rental receivables, power receivables, telecom receivables, lease receivables etc.

However, while several ABS transactions may have assumed a form similar to that of securitisation, the absence of marketable securities available for distribution to several investors would imply that in substance all these transactions partake of the essential characteristics of a structured loan deal rather than of a securitisation transaction. So far, 'Securitisation' in India was meant to imply any of the following distinct activities:

- Structured obligations against receivables (whether loans or debentures/bonds)
- Outright sale of financial/trade receivables without issue of securities
- Securitisation transactions involving assignment of receivables to an SPV and issue of securities backed by these receivables

In the first type, there is no legal true sale of receivables. The lenders/investors rely on a structured payment mechanism for timely servicing of their dues and not on the performance of the assets. Further, the receivables do not go off the balance sheet of the Originator and the lenders/investors continue to have full recourse to the Originator. In the second type, while the Originator would get the benefit of off-balance sheet funding, it fails to satisfy a basic requirement of securitisation i.e. issue of securities backed by these receivables. Securitisation is incomplete unless it involves an issue of (marketable) securities whereby the risks and rewards are channeled into the capital market (at least into the wholesale segment). Thus, only the third type of activity falls under the category of true securitisation as understood internationally.

The first two types are already witnessing some activity from certain lending institutions. Other players in the reckoning are multinationals like GE Capital and Citibank who have been acquiring asset portfolios generated by local NBFCs like Ashok Leyland Finance, 20th Century Finance and other companies like TELCO.

The third type of activity, which would involve issue of tradable securities either in the form of PTCs or structured debentures, is the one that is expected to see larger volumes in the long run. This segment would comprise within it, both corporates willing to raise funds against their assets as also FIs wanting to securitise their loan portfolios. In fact, organisations like HUDCO and Rural Electrification Corporation have already evinced interest in creating a securitisation structure for their future investments in the infrastructure area.

4.6.2 Some of the pioneering transactions that have either been concluded or are being structured in this regard are described in the following sections.

(a) Housing Loans

Housing loan portfolios are considered to be high quality assets with diversified risk and attractive returns. They are by their nature amenable to securitisation. In India however, in spite of outstanding to the tune of Rs 12,000[10] crore in the organised sector, no transaction has yet achieved successful completion. This needs to be analysed in light of the experience in the US markets, where the overwhelming majority of securitisation deals have been of housing loans or MBS.

However, of late there has been a perceptible positive orientation of Government policies towards securitisation for the housing sector. The five-year Plan documents have repeatedly emphasised the need for developing a secondary mortgage market (SMM) for bridging the resource constraint confronting the housing sector. The Ninth Five-Year Plan has strongly recommended securitisation as an important source of funds for the housing sector and has envisaged Rs. 2500 crore to come by way of securitisation. The National Housing Policy (1992) of the Government of India also identified securitisation as an essential measure for generating resources for housing. In particular, it has emphasised the development of a SMM in the country in order to channelise funds from wide range of investors and help integrate the housing finance system with overall finance system, especially the capital market. That

[10] National Housing Bank

securitisation has come to represent a major policy plank of the Government, is further manifested in the recently announced National Habitat and Housing Policy (1998), which lays emphasis on the National Housing Bank (NHB) playing a lead role in mortgage securitisation and development of a SMM in the country. NHB has taken up the issue of securitisation with state Governments through the Ministry of Urban Development.

NHB is now proposing a pilot issue of MBS, as a prelude to the development of a SMM in the country. The pilot project involves securitising a pool of housing loans originated by four Housing Finance Companies. The pool would include unencumbered loans given to individuals for residential houses, in the states of Maharashtra, Tamil Nadu, Gujarat and Karnataka, with maximum loan to value ratio (LTV) of 80%. NHB would act as the SPV and facilitate the transaction. The issue is proposed to be launched in FY 1999 – 2000 and is expected to be a path-breaking issue for MBS transactions in the country. All the major procedural, legal, and taxation issues are in the process of being resolved in this transaction, thus paving the way for classical securitisation transactions to take off in the country.

As with the rest of the world, the potential for mortgage securitisation is enormous. In the case of mortgage securitisation there are specific issues that stymie the process. These are the long tenure of loans, low spreads, cumbersome foreclosure procedures, prepayment risks etc., all of which have led to its tardy progress. A major hurdle in India is simplified foreclosure norms. Once this happens, housing finance institutions (HFIs) will be able to tackle delinquencies effectively and will be willing to lend with less stringent credit evaluation. This is expected to enlarge volumes in the formal sector, helping a wider section of society (who would otherwise have approached the unorganised sector) to borrow at lower rates.

(b) Auto loans – Citibank Case

Citibank assigned a cherry-picked auto loan portfolio to People's Financial Services Ltd. (PFSL), an SPV floated for the purpose of securitisation by paying the required amount of stamp duty (0.1%) to ensure true sale. This is a limited company and can act only as SPV for asset securitisation. This SPV is owned and managed by a group of distinguished legal counsels. PFSL then proceeded to issue 'Pass Through Certificates' to investors. These certificates were rated by CRISIL and listed on the wholesale debt market of the National Stock Exchange (NSE), with HG Asia and Birla Marlin as the market makers. Global Trust Bank acted as the Investors' Representative. Citibank played the role of servicer. The certificates are freely transferable and each of the transfer will have a stamp cost of 0.10%.

The coupon of the security was high in spite of good quality of the underlying asset portfolio, because investors expected a premium to compensate for their unfamiliarity with the certificates. The investor base was limited mostly to MFs. FIs were hesitant because of the unsecured nature of the instrument and the absence of clarity on whether the certificates could be treated on par with other debt securities in their investment policy. Although the certificates were listed on the NSE, there was very little secondary market activity because there was absence of adequate amount of alternative security of similar risk profile.

Besides Citibank, NBFCs like Ashok Leyland Finance, 20th Century Finance etc. have securitised their auto loan portfolio, though, of course, these transactions involved assignment of receivables only and not issuance of securities. The asset portfolios were bought by one or two large institutions. TELCO has also reportedly sold over Rs 550 crore of its auto loan portfolio in multiple tranches through this route.

(c) SEB receivables – KEB case

Another important asset class for the purpose of securitisation pertains to the power sector. The Government is keen to securitise the outstanding dues of various State Electricity Boards (SEBs) and the total market of such receivables is estimated at around Rs.10, 000 crore[11]. However, securitisation of these receivables is feasible provided they are sufficiently credit enhanced, preferably with Government guarantee.

The initiative in this regard has been taken by Karnataka Electricity Board (KEB) who, in a recent transaction, are securitising around Rs 210 crore of their outstanding dues from various State owned public enterprises. The outstanding dues of KEB are being assigned to another State owned subsidiary, Karnataka Renewable Energy Development Ltd. (KREDL) which is acting as the SPV and in turn issuing securities. The securities are being credit enhanced by way of a guarantee from the Karnataka Government with a structured payment mechanism. HUDCO has agreed to be the investor and subscribe to the securities in full.

(d) Future Flows

Traditionally, existing receivables, where receivables are not contingent upon the performance of the Originator were securitised. The asset classes mentioned above viz. housing mortgage, auto loans, industrial loan receivables, etc. belong to the category of existing assets. As mentioned earlier, of late, 'future flow securitisation', is gaining momentum. Remittances from overseas workers, international telephone settlements, export

[11] SBI Capital Markets Ltd.

receivables, future sale of oil and gas and other commodities, project cashflows and toll receivables are finding favour with investors. Some illustrations are given below:

(i) Future receivables - L&T case

The recent case of a power plant construction being financed through the capital markets is an example of future flow securitisation. Although Larsen & Toubro bagged the Build, Lease and Operate contract for a 90-MW captive power plant for Indian Petrochemical Corporation Ltd. (IPCL), it preferred to transfer it to an SPV – India Infrastructure Developers Ltd. (IIDL) which issued debentures in the private placement market. The debentures would be serviced out of the lease rentals due to IIDL from IPCL. L&T's guarantee was also available to a limited extent. The novelty of this transaction is that instead of a plain loan with say, 3:1 debt equity ratio, the project was financed in the form of a securitisation like structure through the capital market with a much higher gearing ratio.

(ii) RIICO case

This was the first attempt at issue of structured debt paper backed by the cash flows arising out of future receivables of a utility. Rajasthan State Electricity Board (RSEB) proposed to raise resources to the tune of Rs.250 crore, but, on account of its weak balance sheet, was not able to access the market directly. A structure was, therefore, devised whereby a pool of receivables comprising RSEB's high value customers was selected based on their payment history. The pool was then rated and credit enhancements were built. While no SPV was set up specifically for the purpose of the transaction, an existing profit-making Government Company, viz. Rajasthan State Industrial Development and Investment Corporation Ltd. (RIICO), was selected as the borrowing entity and the future cash flows and underlying receivables were charged to RIICO. The bonds backed by cash flows were issued by RIICO to various investors by means of a privately placed issue. The investors continued to have recourse to the issuer i.e. RIICO in the event of shortfall in cash flows. The high stamp duties then prevalent, as also certain legal and market-related hurdles, delayed the introduction of full-fledged securitisation at that juncture.

Since the first issuance in 1991, the ABS have been very popular with the NBFCs in India. Over Rs.2000 crore of debt has been raised through this route[12]. The repayment history of all the issues has been extremely satisfactory. The level of cash collateral to support 'AAA' rating has come down (from a peak of 16% to an average of 8%). While the investors enjoyed

a higher yield, the cost to NBFCs was lower than the traditional sources such as bank loans and public deposits. The primary market size of commercial loans and auto loans is expected to be about Rs.11, 000 crore and grows annually by 6% - 8%.

4.7 General

4.7.1 EMs have high cost of raising funds and look for alternative sources for raising funds at cheaper sources. FIs in Asia have large illiquid debt to get rid off. These countries have the potential to benefit from securitisation as soon as the situation improves in South East Asia. Some of the countries in EMs have introduced specific securitisation laws. Eastern Europe offers good scope with the growth of consumer assets; export credit for traditional markets is growing in countries like Poland, Czech republic, Hungary, Slovakia. After the success of securitisation of credit cards and workers remittances in Turkey, other markets in the region like Israel, Lebanon, Egypt are ready for consumer type securitisation. Latin America is already on the path of active securitisation and is well ahead of the other EMs.

4.7.2 There is a huge potential for infrastructure finance in EMs. FIs can securitise their loans for infrastructure projects and the same can be sold to potential local or foreign investors. This presupposes a well-developed secondary debt market.

4.7.3 Government guaranteed loans may remain excluded from securitisation, as they are less efficient.

4.7.4 Privatisation is revolutionising the economic practices in the EMs. Banks are going to the markets for raising equity in the wake of reducing State funding. Their shares are being quoted in the stock markets. They are being forced to improve ROE and the efficiencies of the capital deployed. This gives them the opportunity to consider securitisation in an aggressive way.

4.7.5 Market penetration of FIs in the area of origination of loans will be determined more by the volume of loans originated during a period than by the amount of loans owned at a particular point of time.

4.7.6 Certain potentials for securitisation especially in the mortgage sector in India and elsewhere are as under:

Increasing share of tertiary sector, urbanisation and demand for houses

[12] Citibank, Mumbai

Reduction of poverty and fast development of enlightened middle/upper middle classes in India and elsewhere

Disappearance of joint family system and demand for new houses

Housing initiatives

The increasing size of the middle class and the resultant continuous increase in the demand for new houses as well as loans for renovation will increase the demand for mortgage finance in the EMs in future. Mortgages retain the major share of securitisation so far.

4.7.7 Presently, investors include FIs, special funds raised for the purpose of investment in ABS, pension funds, insurance companies, mainly from USA or Europe. Local investors from Asia look forward for higher returns, as their cost of raising funds is high. Saving rates in Southeast Asia have been 32 percent of GDP versus 21 percent in Latin America, according to ING Baring estimates. Although the local investors' appetite from these EMs is dependent upon the deepening of the markets, the huge savings may provide potential as the process for widening and deepening of these financial markets is taken up.

4.8 Future Prospects

4.8.1 In brief, securitisation will grow in future for two significant reasons:

a) securitised paper is rated more creditworthy than the FI itself

b) strict capital requirements are imposed on the FIs

4.8.2 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. While the benefits that securitisation brings in its wake are well documented, it may however, be worthwhile to examine whether the domestic financial markets are sufficiently developed to accept the product and utilise it efficiently.

4.8.3 The debt market has deepened and widened in recent years in India after the introduction of financial sector reforms. The recent recommendation of the committee on financial sector reforms (Narasimhan Committee Phase II) stipulates that the minimum shareholding by Government /Reserve Bank of India in the equity of the nationalised banks should be brought down to 33%. The same report also emphasises financial restructuring with the objective of, interalia, hiving off non-performing-asset portfolio from the books of the FIs

through securitisation. According to an estimate, Indian banks may be able to raise funds at 200 BP above US Treasury rate for an issue of US$ 150 mn. with a maturity of five years, giving them a gain of 200 to 400 BP. over the domestic rates after taking care of related expenses. The securitised paper can be raised in a period of 16 weeks after signing the mandate with advisors/lead manager. The costs involved are advisors' fee to the tune of 1.5% of issue size, rating agency fee US $ 300,000, legal expenses US$ 500,000 and road shows US$ 100,000. The guidelines of RBI restricting the quantum of the public deposits that can be raised by an NBFC have given them further incentive to look for alternative sources of funds. The opening of the insurance sector for privatisation can create demand for the securitised paper.

4.8.4 The Indian financial system is sound and very well developed. A number of new financial products have arrived and been tested in the market during the brief period since the reforms began. The past few years have also witnessed a healthy trend towards computerisation of transaction and information management systems. The availability of computer technology would thus permit the capture and manipulation of large databases, which are a basic requisite in structuring, securitised products.

The debt market is poised for substantial growth with the development of the sovereign yield curve across different maturities and the active participation of primary dealers.

The Indian market has existing well-developed institutions, specialised regulators in Banking, Capital Markets, Rating Agencies and also a well-developed regime of controls and supervision.

The infrastructure sector has already started witnessing contracting of debt in a tradable form by most lending institutions. This has been concurrent with the advent of Structured Debt Obligations which has in turn familiarised Rating Agencies to 'SO' ratings.

The existence of specialised financing institutions like Housing Finance Companies, Urban / Infrastructure development Bodies like Housing and Urban Development Corporation (HUDCO), Rural Electrification Corporation (REC) etc. who not only have existing securitisable portfolios but also have the capacity to keep creating such assets with a view to securitising them. Since most such institutions are facing resource constraints, securitisation will enable them to focus on their core competency of supporting infrastructure products through the gestation stage and securitising them later, rather than funding them till maturity.

The domestic financial institutions are fast reaching their prudential limits in various sectors. Further lending by them to these sectors is thus dependent upon their being able to securitise their existing portfolios.

4.8.5 The investors with long term funds have traditionally favoured equity and Government securities portfolio and have stayed out of debt. Also the present illiquidity of the loan portfolios does not allow FIs to actively manage or manipulate the related sector, interest rate or maturity risks. This places a restriction on further asset expansion, as assets once taken on the books necessarily need to be carried till maturity. Securitisation will provide solution for their requirements.

4.8.6 The market is thus at a stage where debt is increasingly going to be offered in a tradable form, whether or not secondary market trades take place in individual cases. Securitisation, by converting debt into tradable financial instruments, provides an opportunity for more efficient reallocation of sector specific risks among a more diversified set of players. By offering an exit option, it channelises surpluses that have so far remained untapped, to capital–deficient sectors of the economy.

Chapter 5 Impediments to Securitisation

5.1 General

5.1.1 The ideal conditions for success of securitisation in USA and other countries are important to understand in order to explore business opportunity in EMs. Securitisation owes its existence, in part, to the need for housing finance in USA after the Great Depression. Congress in USA established the Federal Housing Administration in 1934 to provide Government guarantee on certain mortgages. This was followed by the creation of Federal National Mortgage Association (Fannie Mae) as the first Government agency to provide a market in Government guaranteed mortgages. In 1970, in response to increasing housing trend, the Government National Mortgage Association (Ginnie Mae) began to guarantee timely payment of principal and interest on pass-through securities issued by private mortgage Originators and backed by pools of Government-insurers on guarantee mortgages.

Government related agencies continued their activities to encourage development of a secondary market through 1970s and 1980s. They introduced a variety of programmes and securities to attract new investors to the secondary market. The Secondary Mortgage Market Enhancement Act (SMMEA) was passed in 1985 to enable private issuers of securities to compete more effectively with Government-related agencies by removing some of the legal impediments. This included i) permission to banks to invest in privately issued mortgage-related securities & ii) permission for delayed deliveries of such securities thereby allowing a forward trading market to develop. An active secondary market permitted traditional mortgage lenders to liquidate their loans by selling them through Government related agencies or securitising them in the form of MBS. By 1992, pass-through market was comparable to the corporate market size and was substantially larger than the agency market. collateralised mortgage obligation (CMO) securities introduced various tranches with various risk and return characteristics.

The details of development of securitisation in USA, Europe, Australia, Japan, Argentina, Morocco, etc. are given in Chapter 6.

5.1.2 The environment for securitisation in EMs is different from that in the developed markets for various reasons which include (i) Narrow investor base; (ii) Cultural factors; (iii) Poor capital market infrastructure; (iv) Regulatory environment; (v) Legal hurdles; (vi) Lack of proper accounting standards; (vii) Taxation burden; (viii) Poor quality of assets; (ix)

System deficiencies and (x) Lack of standardisation. These are discussed in the following paragraphs.

5.2 Investor base

There is no market without buyers. They may be domestic or foreigners; individuals or institutions – financial or non-financial, regulated or non-regulated; sovereign or non-sovereign. Investors look for (i) Asset performance - Lack of historical or meaningful performance data may make it difficult to predict performance; (ii) Third party performance-Reliance on asset servicers, credit support providers etc.; (iii) Currency exposure and the availability of swap opportunities at reasonable cost; and (iv) Secondary market liquidity. The perceived risks are reflected in pricing in case securitisation actually takes off. Investors also look towards the services of the independent rating agencies to get confidence. An underdeveloped secondary market for securitised assets that lacks liquidity is an obvious problem to an FI in EM that is attempting to find investor acceptance. In India, the following issues need further clarifications:

- The status of 'Pass Through Certificates' as 'Securities' under the SCRA is not clear;
- Investment in securitised paper (whether as PTCs or debt instruments) needs to be specifically permitted for FIs;
- The risk weightage norms for these instruments are not defined. The NPA norms as applicable to securitised debt also need to be clarified;
- Adequate disclosures about the assets need to be made to facilitate the investor to make his/her view on the security.

5.3 Cultural factors

In many EMs, decisions for loans are 'compromised' decisions rather than 'rational' decisions. The process generates loans which are less homogeneous and are not of high quality. Further, nature of 'participation certificates' as distinct from traditional securities such as shares and debentures needs to be recognised. In practice, the FIs as investors look forward to security in the form of creation of charge over physical assets. The mindset against unsecured investments has to undergo a significant change to accept financial claims in the case of securitisation of future flows as collateral.

5.4 Capital Market Infrastructure

Debt markets are at their infancy in many of the EMs due to the underdevelopment of institutions and the instruments.

Further,

- Foreclosure norms need to be simplified to facilitate speedy recovery;
- Securitised paper is not specifically included in proposed notification exempting stamp duty on transfer of debt instruments in the depository mode. This would act as a negative feature vis-à-vis standard debt instruments;
- The market requires the emergence of back-up servicers to protect against any negligence by the Originator (as Administrator)

5.5 Regulatory environment

The regulations in a country for capital adequacy requirements are important motivators for the Originators to undertake securitisation. Clear guidelines for the treatment of true sale and off balance-sheet items can pave the way for securitisation. Further, many financial experts believe that by diminishing the pivotal role of FIs in financial intermediation, securitisation lessens the effectiveness of monetary policy. FIs and regulators in many countries are concerned that the weakening of close ties between FIs and their corporate customers may undermine not only traditional patterns of financial intermediation, but patterns of corporate governance as well. In the Indian scenario, the following issues need further attention:

(a) The guidelines for investments by insurance companies need to be clarified for investments in securitised instruments;

(b) Mutual funds are not permitted to invest in MBS;

(c) The application of current NBFC norms to the Special Purpose Vehicle will render the entire process inefficient.

5.6 Legal provisions

Securitisation is a legal intensive transaction. Different laws apply to different classes of assets. Since all legal provisions connected to securitisation are not consolidated under a single statute, the task of developing a set of sound documents becomes much more tedious. The legal issues in India (including recommendations) are discussed in detail in Chapter 9, which include:

-The Stamp duty on assignment of receivables is not uniform across states and also too high in most states rendering securitisation unviable. While some State Governments have reacted positively by reducing stamp duty on assignment of assets for the purpose of securitisation, resistance has been met with in other States because of the loss of revenue;

-Compulsory registration on transfer of assets involves registration fees, which adds to the cost of securitisation;

Absence of clear legal provisions on

- Partial assignment of assets
- Assignment of future receivables

5.7 Accounting

5.7.1 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.

5.7.2 In case of financial intermediaries securitising their assets, the treatment of the overcollateralised assets in their books needs clarity.

5.7.3 Accounting for securitisation transactions is not clear on

- De-recognition of assets from books of Originator
- Treatment for pass through certificates and the securitised assets in the books of the SPV where the pass through structure is adopted
- Assignment of future receivables and income recognition for the same in the books of the Originator

5.8 Taxation

In order to encourage securitisation, SPV needs to be tax neutral. Other impediments include:

- Transfer of income without transfer of underlying assets still makes Originator liable for taxation;
- It is not clear whether HFCs can continue to issue certificates to borrowers to claim income tax benefits under Sections 24(1)(vi) and 88, after the receivables have been assigned;

Taxation of parties involved in securitisation is not clear, for example

* Capital gains implications on assignment of receivables by the Originator to the SPV
* Possibility of entity taxation of SPV
* TDS on passing on of cashflows by SPV to the investors

5.9 Quality of assets

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.

5.10 System Deficiencies

The following system deficiencies have been identified in the Indian financial system:

- Securitisation requires the Originator to have an efficient information capturing and delivery system. Due to the heavy capital cost involved, both individual Originators and the Indian financial system as a whole are not geared to meet these requirements;
- Information on historical data is generally not available;
- Very little information is available on the demographic characteristics of potential asset pools (such as auto loans, individual housing loans, credit card dues, etc) that are amenable to securitisation;
- Credit information on Originators and potential Originators is also not readily available. Participation from credit bureaus in the process of securitisation is required.

5.11 Standardisation

This refers to FIs and other lenders adopting common formats, practices and procedures in loan origination, documentation, application and administration (servicing).

Th Indian financial system is presently characterised by a lack of standardisation in all aspects of the *loan origination* with the exception of Government sponsored loans or housing loans granted by some of the large housing finance institutions. Each bank or institution uses its own form of contract. Standardisation of a particular category of loan will facilitate securitisation of these loans.

Standardisation does not necessarily mean that all lenders must extend credit using the same criteria or on the same terms but rather that certain fundamental aspects of the lending process are standardised among lenders. For instance, lenders may adopt *a standard form of mortgage loan agreement* that provides adequate legal protection to all lenders. It ensures that investors in a pool of loans (or the rating agencies) do not have to analyse the risk of several different legal documents.

Lenders may also agree to use loan *applications* that request the same information from borrowers. This does not mean that each lender must grant credits on the same criteria but that each lender is obtaining the same basic information from the borrowers making it easier for investors to compare loans originated by different lenders. If applications ask different questions, it is more difficult for investors to evaluate loans originated by one lender against loans originated by another lender.

Standardisation of *servicing* typically involves the standardisation of the type of information that is monitored (i.e. balance, payment history, address, etc.). In addition, there can be standardisation of the documents and information that are maintained in each loan file. There can be standardised data processing systems and software. It can also facilitate a new servicer to take servicing, if required.

These impediments may have to be addressed by the Indian financial community in a phased manner in order to make the securitisation successful in the Indian financial system.

Chapter 6 International Experience

Experience in Developed Markets

6.1 United States

6.1.1 Securitisation market in the US

The United States is the largest securitisation market in the world. In terms of depth, it is the only market where the securitisation market draws participation from institutional as well as individual investors. In terms of width, the US market has far more applications of securitisation than any other market. Approximately 75%, or more of the global volumes in securitisation are originated from the US. Apart from this, securitisation issues originating from other countries like Japan, Europe and some of the EMs, draw investors from the US.

The residential mortgage market of the United States has been subject to successive transformations in financial institutions and instruments.

6.1.2 Background:

(a) With the federal Government having demonstrated the financial viability of home mortgage lending, a private system of mortgage origination, insurance and financing eventually developed to serve markets that were not reached by the Government programs. Partly in recognition of this phenomenon, the U.S. Congress in 1968 split the erstwhile FNMA into two parts - a new FNMA (Fannie Mae) and the Ginnie Mae. Thus, while it rechartered Fannie Mae as a private shareholder-owned corporation to carry out secondary market functions on behalf of Originators of home mortgages that did not carry Government guarantees, the Congress also created Ginnie Mae to securitise Government-guaranteed loans and handle Fannie Mae's policy related tasks. Thus the newly instituted Fannie Mae was moved off budget and set up as a private, Government-sponsored corporation. Ginnie Mae, on the other hand, continues to remain on the federal budget and is a part of the Department of Housing and Urban Development.

(b) During the 20 years following the re-chartering of Fannie Mae, the Government created a competitor corporation to Fannie Mae in the form of the Federal Home Loan Mortgage Corporation (Freddie Mac). Freddie Mac was created in 1970 and like Fannie Mae, it is a private, Government-sponsored corporation (i.e. off budget). Together these three organisations viz. Fannie Mae, Freddie Mac and Ginnie Mae - have emerged the major operators in the US secondary mortgage market.

6.1.3 The rise of secondary market institutions in the US:

(a) The rise in the secondary markets starting from the 1970s and especially in the 1980s came about largely because of standardisation of pools of mortgages brought on by three Government/Government-sponsored agencies – referred to above. More than 40% of the outstanding stock of mortgages in the US is now in pools that trade with the secondary markets.

(b) In particular, a significant institutional development over the past two decades has been the emergence of two dominant Government-sponsored enterprises (GSEs) in the secondary mortgage market - Fannie Mae and Freddie Mac. The financial advantage conferred by their federal charters have permitted both the GSEs to hold or securitise one and a half trillion dollars of mortgages.

(c) Both Freddie Mac and Fannie Mae deal overwhelmingly in pools of conventional (i.e. not federally insured) mortgages. In sharp contrast, Ginnie Mae deals only in federally insured mortgages. It's guarantee on MBS is on top of the federal insurance, and therefore mainly amounts to a guarantee of 'timely' payment. Though all three agencies guarantee their issues against default losses, however, because unlike Ginnie Mae, Fannie Mae deals primarily with conventional mortgages, its risk exposure is larger than that of Ginnie Mae (though they have some protection from private mortgage insurance and from regional diversification).

(d) Because Ginnie Mae is 'on budget' it has a 'full faith and credit' federal guarantee. And because Freddie Mac and Fannie Mae are separate corporations, they both have a nebulous, implicit guarantee and are (or soon will be) regulated by the Department of Housing and Urban Development.

(e) To examine the reasons behind the growth of Fannie Mae and Freddie Mac to become the dominant institutions in the residential mortgage market it is important to note that these institutions are Government sponsored enterprises (i.e. were originally created by the Government). A Government-sponsored institution can be defined as a privately owned, federally chartered financial institution with nationwide scope and specialised lending powers that benefits from an implicit federal guarantee to enhance its ability to borrow money. Fannie Mae and Freddie Mac each are chartered by an Act of Congress to serve as a secondary market institution that purchases and otherwise deals in residential mortgages of a specified size. *The two companies are among the largest financial institutions in the world and purchase roughly half of all residential mortgage debt originated in the US each year.* It should be noted that in the case of these enterprises - the distinction between the primary and secondary market is rooted in law rather than in the marketplace; Fannie Mae and Freddie Mac are authorised to purchase, sell and otherwise deal in residential mortgages but are not permitted to 'originate' them.

(f) In return for the limitations upon the business activities in which they may lawfully engage, and since their activities are considered to embody public purpose, the GSEs receive special benefits. These include various tax and regulatory benefits.

(g) While thrifts are required to hold at least 4% capital to back the residential mortgages they hold, 1992 legislation imposes minimum capital requirements for Fannie Mae and Freddie Mac of 2.5% of total on-balance sheet assets and of 0.45% of MBS guaranteed by the GSEs.

(h) However, the most important benefit enjoyed by GSEs is that while the law provides for a highly competitive primary market (including thrifts, commercial banks and mortgage bankers), by contrast, Fannie Mae and Freddie Mac constitute a duopoly in the secondary market for mortgages and thus wield considerable market power.

6.1.4 Growth of the MBS market: Role of GSEs

(a) MBS are created in two ways. One version (called "Cash") involves selling mortgages (e.g. conventional mortgages made by a savings and loan or a mortgage banker) to either Fannie Mae or Freddie Mac in return for cash. The agencies then form pools out of these loans (sizes vary, some pools are over $ 100 million) and sell shares in the loans to dealers, who in turn sell them to investors. The second way (called "Guarantor" or Swap") involves less work by the Government-sponsored agencies.

(b) For a standard pool of fixed-rate mortgages the fee charged by Fannie Mae and Freddie Mac is around 15 to 20 basis points (0.15% to 0.20%). This fee includes a charge for credit risk and processing, administrating and other costs, net of some "float" income received by the issuer. Ginnie Mae charges a smaller fee, largely because it faces less credit risk, since its loans are federally insured to begin with.

(c) Thus, Ginnie Mae was responsible for the major innovation in secondary markets. Though the FNMA is the oldest of the US Government secondary mortgage market institutions, it was the last to enter the securitisation market. The first FNMA MBS was issued in 1981. SMME Act was passed in 1985 to enable private issuers of securities to compete more effectively with Government-related agencies by removing some of the legal impediments as described in para 5.1.1.

6.1.5 Size of the Securitisation Market:

By 1998, the total volume of securitisation (MBS and ABS) in the USA was estimated at $2.5 trillion with the bulk of it ($1.9 trillion) attributable to Government-sponsored cousins viz. Fannie Mae, Freddie Mac, and Ginnie Mae (which together account for $9 of every $10 of MBS issued).

The other major components of the ABS market include:

(i) Commercial mortgages ($ 200 billion)
(ii) Credit Card and Home equity loans ($ 220 billion)
(iii) Automobile loans ($75 billion)

By the end of 1998, the MBS Outstanding had exceeded the $ 2 trillion mark, whereas ABS were estimated to have reached $ 600 billion. Fannie Mae accounted for the bulk ($ 834.5 billion) of outstanding MBS supply, followed by Freddie Mac and Ginnie Mae at $645.5 billion and $ 538 billion respectively.

6.1.6 Leveraging effects of Government-sponsorship

(a) The federal Government, through implicit and explicit guarantees plays an important role in mortgage markets. It is by virtue of this backing that throughout their more-than-60-year existence, the SMM institutions in the US have managed to play an important and ever-changing role in financing housing. During this period, secondary market organisations have managed to evolve from a single entity that was a part of the national Government to a series of institutions that include private corporations, which retain certain ties to the Government.

(b) Some of the characteristics of Fannie Mae and the strengths it derives from the Federal charter are mentioned below:

   (i) The Secretary of the Treasury has discretionary authority to purchase upto $2.25 billion of the corporation's obligations. This treasury authority has never been used.

   (ii) The President of the US appoints 5 of Fannies Mae's 18 directors.

   (iii) Fannie Mae MBS are acceptable as security for the deposit of public monies subject to the control of the US or any of its officers.

   (iv) The Open Market Committee of the Federal Reserve System is authorised to buy and sell Fannie Mae securities in its day-today implementation of monetary policy.

   (v) The Secretary of the Treasury must approve the timing and terms of issuance of Fannie Mae debt.

   (vi) Like Treasury securities, US national banks and state-chartered banks that are members of the Federal Reserve System may deal in, purchase and hold for their own accounts Fannie Mae securities without limitation.

   (vii) Fannie Mae MBS are eligible as security for advances to depository institutions by Federal Reserve banks.

   (viii) Fannie Mae debt and MBS generally have the status of securities issued by a 'US Government-sponsored agency' under US risk-based capital regulatory guidelines, which were adopted following the Basle Accord.

It would, thus, appear that there is a strong Government presence in the housing finance sector. The Government, however, does not directly participate in the secondary mortgage market. The backing of the federal Government and the implied Government guarantee to a large proportion of the MBS outstanding has generated confidence among the investors and given stability and growth to the market. *Government sponsorship has leveraged the activities of both Fannie Mae and Freddie Mac, and their success in turn, has spurred the growth of private mortgage securitisation all across the US.*

What is of particular interest is how both Fannie Mae and Freddie Mac, which are stockholder-owned private corporations yet federally chartered and with a public mission to fulfill, have successfully steered the US housing finance sector to its present preeminent position. It may be worthwhile to incorporate these lessons in experience into the Indian mortgage securitisation context.

6.1.7 Non-Performing Assets (NPA):

Box Securitisation of impaired assets[13]

A major extension of application of securitisation has been the activity of Resolution Trust Company (RTC) during 1992 to deal with the problem of insolvent saving and loan institutions (S&Ls or thrifts). After using variety of techniques to dispose off failed institutions, including sales of entire institutions, and of individual securities, other assets including consumer receivables, were securitised. These securities received credit enhancement through subordinated paper and overcollateralisation and through reserve funds which RTC was pledged to maintain. A number of somewhat more difficult claims were eventually securitised in large numbers, including single-family mortgages with high delinquency rates and pools of residential multiunit residential mortgages. Most RTC securitisation of this kind have been rated AA or AAA.

Having disposed of easily saleable assets in this manner, it was necessary to turn to assets that were progressively harder to sell. In doing so, RTC encountered problems similar to those that have hampered securitisation of commercial mortgages, including the large size of individual loans, highly specific terms which limit homogeneity and transferability, problems in developing statistically credible payment histories, and difficulties in obtaining acceptable diversification. Nevertheless, RTC was able to securitise pools of commercial mortgages

[13] OECD. *Securitisation-An International Perspective.* France:Thompson, 1995.p.29.

with enhancement. The different tranches of these securities have been rated from AAA to BBB. Some have been done at fixed rates, and others at floating rates.

RTC had to sell still less liquid assets. There was a large number of non-performing or underperforming mortgages, which required foreclosure, or renegotiations of terms, as well as real estate directly owned by RTC as a result of foreclosures. The property was sold at market value, which was obviously below book value and the investor assumed control in return for an asset with potential for appreciation, provided that the assets were managed properly. While the senior tranches, which were rated AA or AAA, were widely distributed, the "hard to sell" assets, particularly subordinated tranches, were mainly sold to single investors who wished to maintain control over properties.

The technique developed in liquidating failed thrifts may have wider applicability especially in assets of FIs in EMs. It was possible to sell large amounts of assets , many of which were not easily marketable, in a comparatively short time. By selling assets relatively quickly, the need for Federal support was limited. RTC retained equity to sell large amounts of assets, many of which were not easily marketable, in a comparatively short time. By selling assets relatively quickly, the need for Federal support was limited. RTC retained equity position in many subordinated debts. Many agreements provided for sharing of any gains on sale of the assets. Many of the deals were structured so as to provide investors with marginal control and strong incentives to maximise rates of recovery on assets.

It is interesting to note that NPAs of FIs have also been securitised in USA. One of the issues for the EMs is how to deal with a substantial portfolio of NPAs. As has been experienced in the case of the securitisation of the assets of Resolution Trust Company in the US, these assets can be securitised if they are managed well, have the potential for appreciation and the buyers get opportunity to participate in management. Securitisation can be part of a general programme to rehabilitate financial system. 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 decline in the quality of bank balance sheets and the overhang of bank claims on distressed sectors (e.g. priority sectors in India) mean that banks in several countries are intent upon reducing the size of their balance sheets and making as many assets as possible tradable.

6.1.8 General

The growth in securitisation in developed markets like the US has been concurrent with several other linked developments. These are:

- Increased competition amongst financial intermediaries following de-regulation;
- Regional and sectoral imbalances in capital distribution;
- Regional imbalances in risk profile of borrowers'
- Imposition of capital adequacy standards and increased emphasis on returns on capital;
- Uneconomical spreads leading to a search for fee rather than margin income;
- The deterioration in credit ratings due to weak credit controls and competition;

The US markets have historically been more liquid, innovative and sophisticated. Developing markets on the other hand, are fragmented and small. Nevertheless, the imperatives that acted as principal drivers in the US markets have either already arrived or are beginning to become visible in developing markets also.

6.1.9 US assets securitised outside USA

Issuers of securities backed by assets in US have accessed Euro and Japanese markets with increasing frequency. This phenomenon parallels the broader globalisation of capital markets in general, which has enabled issuers to optimise pricing and terms of securities issued, sometimes through overseas issuance of a security with a particular currency and type of interest rate (fixed or floating), combined with currency or interest rate swaps.

6.1.10 Securitisation outside USA

Australia has a market size of A$ 10 bn. and is dominated by residential mortgages and commercial property leases. In Japan, securitisation is largely undeveloped with transactions confined to about US$ 4.8 bn.[14]. In Asia, assets worth only US$ 2 bn. have been securitised, half of which were in Hongkong[15]. India, Indonesia, and Thailand are the future markets on horizon with a few deals of low volume having been concluded in each country. In Latin America, securitisation transactions were up from about US $ 3.67 bn. in 1995 to 10.3 bn. in 1996. In South Africa, very few transactions have taken place although the Government has enacted a special law in 1992.

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[14] Duff and Phelps Credit Rating India Private Ltd. *Securitisation in India : A position paper.* Mumbai, May 1997.

[15] ibid.

6.2 Europe

6.2.1 Growth of the market:

(a) Securitisation originated not in the United States but in Denmark - a mortgage credit system has existed in Denmark for over 200 years now. There is also pfandbrief market in Germany, which is a secondary mortgage market, but the Danish mortgage trading system is very close to the US concept of pass throughs.

(b) Securitisation in the modern sense emerged in Europe in the mid-1980s with the issuance of MBSs in the UK. The early mortgage-backed market was driven by a new breed of so called centralised mortgage lenders which had mortgage origination capabilities far in excess of what they could book on their own balance sheets. Securitisation proved to be a natural and tailor-made option in this situation.

(c) For MBS, the UK has been the major source of collateral; in fact, till recently; three countries (the UK, France and Spain) provided the collateral for almost all MBS issues. A notable entry into the MBS market was Germany, the largest mortgage market on the continent in terms of amount of loans outstanding, where three large deals were issued in 1998. In recent years, securitised instruments in Germany are reckoned as amongst the best debt securities, with the German market absorbing the securitisation process into its financial system well.

(d) Asset classes securitised in Europe have largely fallen into three main categories: residential mortgages, other small ticket consumer and corporate financial obligations, and Government supported flows. Suppliers of goods and services to Governments have taken to repackaging their sovereign debtors into tradable notes and bonds. Credit card receivables, property rentals and utility contracts have also been favoured asset classes.

(e) According to estimates by Moody's Investors Services, annual issuance of European MBS/ABS was less than $10 billion until 1996, when it jumped to $30 billion, then further increased to $45.4 billion in 1997. Volume for 1998, however, was about the same as 1997, at $46.6 billion, as the flight to quality towards the end of 1998 led to a dramatic widening in ABS spreads and reduced issuance to a trickle. The total outstanding volume of European MBS/ABS has been estimated to be about $130 billion, of which perhaps half is MBS.

6.2.2 Regulatory initiatives to promote securitisation:

Enabling laws and regulations in France, Italy, Spain and Belgium have been the leading factors in the growth and spread of proprietary European securitisation since the early 1990s. The most significant regulatory change that Europe has seen took place in May 1998 when German banks were given authorisation to securitise their own loans.

6.2.3 The problems hindering the growth of securitisation in Europe are:

- Many institutions have not faced strong incentives to remove assets from balance sheets, because of favourable funding rates and excess capital;
- The severe recession in Europe in the early 1990s led to a sharp drop in loan origination, further diminishing pressure on balance sheets;
- A lack of legal and regulatory frameworks;
- Few analytic tools and an infrastructure exist for timely reporting of deal information to investors;
- A diversity of mortgage terms and conditions from country to country, such as different prepayment penalties, diminish the appeal of MBS backed by loans from one country to investors in other countries;
- Currency differences have hindered cross-border transactions in the past; and
- Many European investors have tended to focus on sovereign debt, rather than spread products.

6.2.4 Future of securitisation in Europe:

(a) With Europe representing the largest international market opportunity for increased securitisation deals, bankers predict that activity in the region is likely to expand, both in value and scope, over the next five years. The financial community is extremely optimistic about the prospects of ABS issues after the introduction of Euro.

(b) The following factors point to the growing market for securitisation in Europe:

- The introduction of the Euro is expected to have a major impact, because it will gradually eliminate much of the existing sovereign bond markets, shift investor attention to spread products, especially MBS and ABS because of their high credit quality, and eliminate currency concerns;
- In the past few years, various countries have made legal and regulatory changes that facilitate securitisation, and this trend is expected to continue;
- Competitive and regulatory pressures on institutions are mounting, leading to more focus on measures such as return on equity and on efficient balance sheet management;
- Gradual improvements in MBS deal information reporting systems and more familiarity with cash-flow characteristics should contribute to increasing investor comfort levels with MBS and ABS products; and
- There has been a continuing broadening of the types of assets being securitised - for example, sub-prime mortgages, student loans, soccer receivables, pub leases, and so on.

Commentators lament that there is no equivalent of the US-type Ginnie Mae or Fannie Mae in Europe - so if securitisation markets have to grow, it is solely out of the needs of the savvy issuers and investors.

6.3 Japan

6.3.1 As late as 1998, the Japanese Diet enacted several laws that are likely to speed the development of a thriving securitisation industry in Japan. Regulators, too have lent their assistance by promulgating regulations that will help clarify some of the outstanding issues that have, so far, plagued the development of Japanese asset securitisation as a viable means of finance.

6.3.2 The Japanese Government has high expectations from securitisation and sees its proliferation as an integral part of the financial liberalisation programme it is instituting. Interestingly, the Japanese Government also sees securitisation as the solution to Japan's bad loan crisis, which has reached the $ 1 trillion mark. While as recently as 1996, over-regulation and the consequent prohibitive costs of securitisation had led many observers to conclude that securitisation may not take off in Japan, the pessimistic sentiments have undergone a complete reversal with these new developments in place.

6..3.3 As securitisation-related financial techniques continued to develop, the development of a general legal framework, which provided measures for investor protection, was necessary. For this purpose, structural reform legislation amended the Japanese Securities and Exchange Law (SEL) to expand the definition of a "security." In April 1996, the Cabinet Order that accompanied the Miti Law was revised to permit an SPV organised under the Miti Law to issue true ABSs.

6.4 Australia

Government sponsored mortgage programme was initiated in Australia during mid 1980s. Reserve Bank of Australia released prudential guidelines for securitisation during 1995. Banks and their subsidiaries have the largest pool of assets, which can be securitised. Australia has well defined foreclosure laws. The securitised instrument ranges from tenure of 30 days (commercial paper) to MBS bond with a legal life of 30 years. There is a clear separation between the Originator and SPV; an Originator cannot own or control the SPV. The credit enhancement facility is limited in amount and time frame. Regarding the SPV structure, there is a complete tax exemption in case of trusts. In the case of corporate, the tax exemption is given in case the inflow and outflows are matching. During 1998, the share of offshore issues increased significantly compared with the domestic issues.

6.5 Thailand

The first Thai securitisation transaction took place in the autumn of 1996 involving auto receivables. The Asian crisis resulted in the demise of most of the finance companies and a number of financial intermediaries. This affected the progress of securitisation temporarily, till the enactment of the securitisation law (discussed below).

6.5.1 Legal initiatives to promote securitisation:

Recently, the Thai Government enacted a long-awaited securitisation law called Specific Juristic Person for Securitisation Enactment. The law primarily has the following features:

(a) It defines securitisation and the assets that can be securitised. The regulation of securitisation transactions has been handed over to the Securities and Exchange Commission (SEC). *The law clarifies that the business of the SPV was not a finance business, which would have required a licence.* Entities that can benefit from the law include commercial banks, finance companies, credit financiers, securities companies, etc. Conduct of securitisation transaction would require the approval of the SPV by the SEC. One of the most important effects of the new law is that it overcomes a basic problem of Thai law that requires an assignment of a debt to be backed by notice to the debtor. *The present law eliminates the notification requirement, if the Originator is also the collector.*

(b) Another very important impact of the new law is that the transfer of assets from the Originator to the SPV, backed by mortgage, pledge or guarantee, will be exempt from tax on transfer. Thus, the VAT problem, discussed below, is resolved as far as mortgage-securitisations or other asset-backed securitisations are concerned.

(c) Again, one of the problem areas in Thai securitisation was the possible annulment of the transfer of assets upon the bankruptcy of the Originator. The source of the problem was Sec. 114 of Thai Bankruptcy Code. This problem is resolved by making the Bankruptcy Code inapplicable in case there is a qualifying transfer of assets from the Originator to the SPV. In order for the transfer to qualify, the following are the conditions: (a) the transaction is done at fair market values; (b) the risks and rewards in the assets are transferred to the SPV; and (c) the collateral backing up the assets are also transferred to the SPV.

(d) Though the implementation of the securitisation law has resolved a number of problems inherent in Thai law, the problems remain, in cases where the law does not apply. *For*

example, lease transactions may not be covered by the provision, which exempts the VAT application to transfer of assets. This apart, the law applies only to securitisation by financial entities.

(e) Outside of the securitisation law, a securitisation transaction in Thailand is fraught with many problems - to begin with, the very concept of trust is alien to Thai law, which is different from the English common law system and closer to Civil Law. Assignment of receivables not only requires notification to the debtor, in fact, sec. 306 of the Civil Code provides for a prior sanction of the debtor in order to lawfully assign a receivable, unless the notice of assignment has been served in a proper manner. Registered post is considered as a proper mode of servicing the notice.

(f) Since the Thai law does not recognise trusts, there *are legal issues relating to commingling of cashflows where the Originator also acts as the servicer.*

6.5.2 Taxation of securitisation:

Two taxes that affect a securitisation deal in Thailand are - the Value-added Tax (VAT) and the Specific Business Tax (SBT).

(a) VAT leads to a 10% levy on all sales of goods and services. The definition of "goods" is wide enough to cover incorporeal rights having value. Therefore, transfer of receivables under securitisation transactions are easily trapped by the definition. As noted earlier, the applicability of this tax is exempted on transactions covered by the securitisation law. However, transactions not exempted will be hit, and the tax would really make a transaction unworkable, since the VAT paid at the time of transfer will be irrecoverable. To circumvent this problem, some of the transactions in the past were structured as loans, i.e., the assignment of the receivables from the Originator was taken as a collateral to secure a loan. This solution, obviously, kills the very purpose of securitisation, which is to isolate the assets from the Originator and achieve predominant rights therein with the investors rather than the Originator.

(b) Another tax, applicable on specific businesses, is the SBT. The scheme of the revenue is that on specific businesses, VAT would not apply, and SBT will. SBT is applicable on financial businesses such as banking, finance companies, credit financiers, etc. The levy is 3% of the receipt by way of interest, discount, etc. In case of securitisations by financial entities, it is felt that this levy is applicable rather than VAT, and the impact of this levy is far lesser than that of VAT. SBT is applicable, on the profit from the transfer of receivables, that is, the difference between the discounting rate and the inherent rate

of return in the portfolio. This tax can be staggered by transferring the receivables at their inherent rate of return, and extracting profit later by way of either servicing charges (in which case the income may suffer VAT rather than SBT!) or residuary income. However, the tax is only deferred, not avoided.

Withholding tax is applicable to interest payments to individual investors, exempt in case of corporate investors.

6.6 Indonesia

6.6.1 The first securitisation transaction in Indonesia was in August 1996 by PT Astra Sedaya Finance involving an unregulated finance company's auto loan receivables. There were two more transactions involving auto receivables in 1996 and 1997. Besides, there were some credit card securitisations. Even as the market was poised for substantial growth, the Asian currency crisis of 1997 crashed all potential deals. There has been a lull in activity since then.

6.6.2 Legal initiatives to promote securitisation:

(a) In general, the Indonesian legal environment, with a Roman-Dutch system, is friendly towards securitisation. Receivables can be assigned in such a way that they would not be treated as part of the seller's estate if it becomes bankrupt.

(b) Being a civil law jurisdiction, an assignment of a receivable under Indonesian law will be treated as bilateral contract between the assignor and the assignee and will be binding upon the Obligor only when a written notification has been given to the Obligor or the Obligor has consented to the assignment. The formal method of notification permitted under law is reflective of the archaic Roman system: the notice will be delivered by the offices of the Court. This being impractical in most cases the assignee mostly keeps the assignment incomplete by not giving a notice of assignment upfront, but reserving the right to give the notice, either in his own capacity or as holder of power of attorney of the assignor, at a later date if the trigger of default arise.

(c) Indonesia also has some difficulty in defining the legal structure of the SPV. Trusts are not known in Indonesian law; some of the securitisation SPVs have been incorporated as "multifinance companies", an Indonesian version of finance companies engaging in several financial services.

(d) Indonesia embarked on a plan to encourage securitisation, particularly in the local market. BAPEPAM, the capital markets regulator, produced a set of proposals for the regulation of on-shore securitisation including a mechanism for establishing on-shore SPV using some form of mutual fund.

6.6.3 Taxation of securitisation:

Two tax issues continued to prove problematic.

VAT: Thought there is no VAT on the sale price of the receivables, VAT @ 10% is imposed on fees including any servicing fee, and therefore in most deals the excess spread in the transaction is paid to the Originator as deferred purchase price.

Withholding tax: A more difficult structuring challenge involves the issue of withholding tax on interest payments off shore. There are conditions for exemption from this requirement that require creation of taxable SPV in Indonesia. The transactions in the past have circumvented withholding tax by bringing an exempt entity and selling the interest as a separate strip to such exempt entity. However, it is doubtful if such a structure would be permitted by the tax authorities.

6.7 Argentina

6.7.1 Among Latin American markets, Argentina takes a lead: both in terms of the maturity of the market, depth and width of transactions and a generally well defined legal system that permits and promotes securitisation. The Government's policies have generally been receptive. The passage of the Trust Law in 1995 has been an important contributor to the growth of securitisation markets in Argentina.

6.7.2 On the mortgage loans front, the Argentina market is characterised by large market share in mortgage loans with just one bank, Banco Hipotecario Nacional (BHN). With a permissive environment being laid out by changes in securities and banking laws (discussed below), BHN completed the country's first two securitisations in 1997. The first was a US$93 million issue with a 76:24 blend of variable rate and fixed rate mortgage respectively. The second issue was US$106 million with at 47:53 blend of variable and fixed rate mortgages. The senior securities achieved an investment grade rating in the US (higher than the Argentine sovereign rating at the time of issue) through the use of senior subordination and reserve funds for credit enhancement. There have been some securitisation deals in export receivables as well - YPF Sociedad Anonima has closed some issues relating to export receivables for sale of oil to Chile. Oil royalties have also been securitised by one of the State Governments. In 1998, there were 4 international securitisation deals from Argentina: Banco Mayo's personal loans, Oil Enterprises future oil sales, a third deal of coparticipation tax revenue receivables, and lastly a credit card receivables securitisation. Domestically, there were about a dozen transactions.

6.7.3 Securitisation law:

(a) In view of the growing investor interest in securitisation transactions, the Argentine Government adopted in 1995 a law on securitisation transactions. The Housing and construction law [no 24,441], actually a Trust law, adopted on January 9, 1995 (an umbrella legislation) contains comprehensive provisions relating to securitisation transactions which, together with Resolution No. 271 of National Securities Commission –CNV (published on September 1, 1995 – similar to rules framed by SEBI in India) delegates to the CNV power of regulation of securitisation transactions.

(b) The Trust law states that the property transferred in trust constitutes a separate estate from that of either the trustor or the trustee. Further, the trust property is exempt from any claims of the trustee's creditors and, except in the case of fraud, the trustor's creditors. The obligations of the trust may only be satisfied from the trust property.

(c) The trustee is a financial institution or an entity authorised by the CNV to act as financial trustee and the beneficiaries are the holders of certificates of participation in the trust property ('certificates") or the debt instruments guaranteed by the trust property ('debt instruments"). The certificates and debt instruments may be issued in bearer form or registered in the holder's name, may or may not be endorseable, may be issued in definitive form or book entry form, or may be issued in global form for centralised depository purposes.

(d) In Regulation 271, CNV provided that financial trustees may be financial entities authorised under Argentine law, entities registered in the Register of Financial trustees held by CNV and the financial institutions chartered by the Central Bank of the Argentine Republic. In order to be included in the Register of Financial Trustees, an entity must be a corporation or, in the case of foreign company, must have a branch or other form of representation in Argentina; its legal purpose must include serving as a trustee; it must have a net worth of at least 100,000 pesos; and it must have an adequate administrative organisation to perform its duties as financial trustees, although administrative services may be contracted out.

(e) The Trust by law provides that interest payments made in respect of debt instruments and certificates to foreign beneficiaries are exempt form Argentinean income tax so long as the trust is created with *the purpose of securitising assets, the public offering of those securities is authorised by the CNV, and the securities are publicly offered in Argentina.*

6.7.4 Other provisions :

- Upon or after signing the trust agreement, and in accordance with its terms, the trustee will be the transferee of the assets or rights which are the subject of securitisation and as of that moment, the trustee will be endowed with title, in trust, to the rights to such principal, interest fees, collateral security etc., which title and rights may not be challenged by third parties if the transfer and the registration are carried out in accordance with the formalities required by the applicable law.
- The transfer of the rights to receive payments to the trustee is binding on the third parties, including the original debtor, as of the moment such party is notified except in the case the debtor has previously agreed by contract to be bound without prior notice.
- The portfolio of loans that may be transferred and held by a trustee will at no time be considered part of the trustee's assets for bankruptcy or other purposes. The transfer may only be challenged by the original debtor in the event the transferor transferred invalid loans or that payment by the original debtor was effected prior to the transfer.
- The Trust Law also establishes certain requirements for the creation of loans, which are guaranteed by mortgage notes. For instance, origination expenses for mortgage loans may not exceed 2% of the price of the sale or of an independent valuation.
- The securities if issued pursuant to the public offering regulations and approved by the CNV, will be exempt from various taxes including the VAT, interest withholding tax, income and capital gains, as well as other taxes.
- Under the Argentine **bankruptcy** code, the court will set a period of suspicion as existing prior to the request for bankruptcy, in which certain transfers will be set aside if, at the time of the transfer, it was reasonably evident that the entity (in this case the transferor company) was unable to pay its debts in a timely manner and, among other indicators, if the purchase price was not for fair value. This period fixed by the bankruptcy judge at no greater than two years before the declaration of bankruptcy, is determined by the court to have begun when the debtor has suspended its payment obligations. Article 86 of the bankruptcy code of Argentina indicates a number of criteria which the court may consider as evidence of the date upon which the debtor can be considered to have entered into such a suspension of payment obligations, in order to fix the date of suspension period, including delay in compliance with obligations, the closing of the administrative offices of the debtor, fraudulent transfers or transfer of goods in payment of obligations or their sale at an unseemly price, and fraudulent attempts to obtain funds.

6.7.5 The special procedure for the **foreclosure** on mortgages established under the trust law may be utilised for mortgage notes and all other mortgage loans in all cases so long as there was no express agreement by the borrower to be bound by the provisions of title V of the trust law. Under such procedure, when there is a delay of 60 days in the payment of the principal or interest, the creditor may notify the debtor of the default, allowing 15 additional days for the delayed payment in full to be received, after which the process of extra judicial foreclosure on the mortgage through an auction may begin. The debtors should also be notified that the extra judicial foreclosure might occur. Thereafter,

- The creditor may then proceed to present before the appropriate court an action by presenting the mortgage note. After allowing 5 days, the court may proceed to set period of 10 days to vacate the premises, after which the debtor may be forcefully evicted. The creditor would then seek a report from the property registry as to whether any other liens exist and their order of priority to determine if there are claims on the property. The creditor may avoid using the courts altogether and utilise the extra judicial mechanism after requesting the property registry issue a report verifying if there are any liens or other claim outstanding.
- Specific public notification requirements to foreclose on the mortgage are stipulated prior to the auction and 7-day notification requirements in the case of debtor holding title to the mortgaged property also apply.
- In the auction, the initial bid must be the amount of the debt in default, and once the property is sold and paid for, expenses related to the sale may not exceed 3% of the loan. Proceeds from the sale along with pertinent documentation shall be deposited with the competent court within 5 days of the auction, which will give the debtor 5 days to challenge or accept the liquidation of the proceeds.
- After the sale of the property and full payment of the offered price, the sale may not be challenged by third parties.
- The only defences available to the defaulting debtor are:

-default has not occurred

-payment was not demanded

-the methodology used had not been agreed upon

-lack of proper notice

- If the loan is not paid in full from the proceeds of the auction and sale, creditors may seek judicial assistance to liquidate any remaining debt

6.7.6 The securitisation law allows the creation of two different types of securitisation structures. In the first case, the pool of securities is held by an SPV, which in turn issues certificates of participation including debt securities, backed by underlying receivables. In alternative form, a third party buys the entire pool of receivables and places them in a trust, which can be used as collateral for debt securities issued and guaranteed by the buying party. CNV regulations impose certain requirements on the appointment of trustees for the SPV. There are certain minimum capital requirements also in order to be appointed as a trustee.

6.8 Hong Kong

6.8.1 Hong Kong is in the forefront of the Asian securitisation scenario, as it is also probably the most securitisation-friendly jurisdiction in Asia. The regulatory environment including the set of guidelines for regulatory off-balance sheet treatment for regulated institutions largely follows the Bank of England model.

6.8.2 The Hong Kong Mortgage Corporation (HKMC), wholly owned by the Government through the Exchange Fund, was incorporated in March 1997 with the mission of developing Hong Kong's secondary mortgage market. The HKMC is a public limited company incorporated under the Companies Ordinance. Its business is being developed in two phases. The initial phase involves the purchase of mortgage loans for its own portfolio and funds the purchases largely through the issuance of unsecured debt securities. In the second phase, the HKMC will securitise the mortgages into MBS and offer them for sale to investors.

In July 1999, the Board of Directors of the HKMC gave its approval in principle for the Corporation to launch MBSs under a pilot scheme. Under the proposed scheme, the HKMC will purchase mortgages from individual banks and then transfer the mortgage pool to an SPV. The SPV will then issue MBSs back to the originating bank with the HKMC's guarantee of the timely payment of principal and interest in return for a guarantee fee. The bank can either hold the MBS in its own portfolio or on-sale the securities to other investors. The experience to be gained from this relatively simple structure will be valuable for the subsequent launch of more complicated MBS products.

6.9 Morocco

6.9.1 Umbrella legislation has been enacted in Morocco encompassing all the aspects of and facilitating securitisation of ABS and MBS through a debt investment fund, SPV. The only operations authorised under this law are:

- limited securitisation operations comprising transfer of housing mortgage receivables, provided these operations are carried out by a credit institution with a minimum capital of DH 1,000,000; and
- other securitisation operations including a public offer specifically covered by order of the finance minister or by an implementing law authorising these operations in each specific case.

6.9.2 Structure

The SPVs can be (i) institutional investors in debt or (ii) other entities which are governed by the legislative or regulatory systems of either Morocco or other foreign countries. The SPV is a separate and autonomous body (not a legal entity – commercial or a non-commercial company) and has the capacity of a natural person. All its functions are administered by its management depository institution, akin to asset management company (AMC) in India. It has been considered advisable that for each securitisation operation by an Originator, a separate SPV is created exclusively for that operation.

6.9.3 Rules of formation of SPV

The minimum framework of rules within which the SPV is founded has been specified in the Act covering the duration of the SPV, particulars of its AMC and the financial intermediary, a description of the planned securitisation operation, nature of assets to be transferred to it, minimum and maximum amounts of intended issue, frequency and nature of mandatory information to be provided to its investors, procedures for meetings with its investors, dissolution of the SPV, etc. As a result of its exclusive purpose for securitisation operation, an SPV cannot undertake any activity or assume any responsibilities other than those prescribed in the rules of its formation.

6.9.4 Minimum disclosure norms

The Act specifies that the rules of formation of the SPV must include the frequency and the nature of mandatory information to the provided to the investors irrespective of whether it is a limited securitisation operation or a public offering. Any Originator or the financial intermediary holding or acquiring direct or indirect interest in the AMC must disclose the fact in the rules of the SPV and the information to be furnished to the investors. The AMCs are required to furnish a copy of the annual report on the SPV and if required by the rules at a greater frequency, duly certified by an auditor.

6.9.5 Separation from the assets of its Originator and AMC

The transfer of the receivables is absolute and cannot be cancelled for any reason even if the Originator becomes insolvent or enters liquidation. The receivables once transferred to the SPV are to be removed from the balance sheet of the Originator. Further there is no guarantee from the Originator about the solvency of the debtors.

6.9.6 Issue of shares or bonds

It can issue shares or bonds fully or partly secured by its patrimony, which includes all the assets acquired by it through the securitisation process and all other rights. The rules also permit ranking, preferences or priorities among the bondholders but no other guarantee is provided to them except the assets of the SPV. However, they cannot distribute the assets of the SPV among themselves during the currency of its existence, thus making it immune to liquidation proceedings from its debtors or investors. The shares and bonds issued by the SPV are permissible and approved investments for the institutional investors, financial companies, credit institutions, enterprises governed by insurance and reinsurance legislation, retirement and pension agencies, etc. The Government can also make it mandatory for any one of the aforesaid institutions, enterprises or agencies to keep a part of their assets in these securities. However, these securities can be transferred only among the permitted investors.

6.9.7 Notice to the debtors

There is no mandatory requirement of notice to the debtors of the transfer of receivables to the SPV. It can be reported to the debtors by a simple letter and comes into force from the date it is posted and the debtor is required to pay the person indicated in the notice. *However, as long as the debtor is not notified of the transfer of the receivables to the SPV, he may make payment directly to the Originator and discharge any obligation vis-à-vis the SPV. In such an event, the Originator is required to keep the amounts so received in a separate bank account opened in the name of the AMC. Such balances are separate from the asset of the Originator or any other person and can be claimed by the AMC at any time without regard for the customary or legal priorities or privileges which means that even the revenue authorities cannot appropriate such sums towards their dues.*

6.9.8 Transfer of mortgage debts

The recording of transfers of mortgage receivables in the real estate matters is to be governed, notwithstanding any laws or regulations contrary to the provisions of this law. Even the requirement of prior conveyance of the real estate in favour of the Originator in respect of

mortgage receivables being transferred as a part of the securitisation operation is waived and the conveyance can take place and produce effect between the Originator and the AMC on the same date against the third parties whether or not the conveyance was recorded. This recording takes precedence over any other request concerning the property in question which is submitted on the same date and is performed despite any attachment of the property encumbered by the mortgage in question. All doubts or conflicts are to be decided in favour of the SPV and against the debtor of the mortgage receivable transferred. The transfer of mortgage receivables is exempt from the application of time limits stipulated in the relative laws. However, every registrar of the landed property, the debtor and the third parties responsible to make payment to the account of the debtor should be notified of the transfer of a mortgage receivable by registered post.

6.9.9 Transfer of other assets

The transfer of other assets would also be in conformity with the principles set forth in this law and would take into account the adjustment required as a result of the specific nature of the assets in question subject, however, to the conditions and procedures for their transfer to the regulations or implementing legislation or by the applicable rules of common law. However, the provisions of this law would have an over-riding effect, in relation to the transfer of the legal rights and the conditions of their transfer, if such agreements or legislation or regulations were inconsistent with this law.

6.9.10 Accounting principles and Auditors' responsibilities

The SPV is required to follow the accounting rules approved by Government in consultation with National Accounting Council equivalent to ICAI in India or failing this, those, which are in conformity with the accounting rules generally accepted in Morocco. The auditor has been assigned a permanent role in the auditing of the books of the SPV, verification of the consistency and the authenticity of its accounts as also the information related to its financial position prior to its being released.

6.9.11 Exemptions from the costs

The SPVs, the AMCs and their appointed administrator, as well as holders of shares and bonds and distributions and payments to these holders, are completely exempt from the following taxes and fees :

- the fee levied, if any, on the registration of landed property and other assignments ;

- registration fees and stamp duties payable on the instruments related to their formation and their acquisition of assets, the issue and transfer of shares and bonds, other instruments related to the operations of SPVs;

- the VAT on services provided by AMC and all other taxes, payments, or operations which are part of a securitisation operation, including but not limited to hedging operations, distributions to shareholders, and payments to bondholders;

- the corporate tax and contributions to national solidarity for all payments received as assets sold or transferred and for all distributions to shareholders or payments to bondholders;

- the tax on stock dividends, partnership shares and the proceeds from fixed-income investments or similar other income; and

- the gains or losses realised by the Originator on the transfer to the SPV are spread over the Originator's financial years remaining till maturity on the receivables transferred.

6.10 General

6.10.1 EMs generally have a gap between their investment requirements and available savings. Saving rates are either low or don't get channelled to the investments due to the underdevelopment of the financial markets. The ability of an FI in an EM to borrow capital from international investors can be vital for its growth and survival. FIs can issue securitised debt to access international markets for funds otherwise unavailable, either locally or internationally. Long-term debt markets are particularly underdeveloped in EMs. It is predicted that MBSs can lower mortgage rates by 2% once efficiencies are achieved in this method of financing.

6.10.2 Investors for securitised paper are generally i) Fixed Funds: US life companies, money managers, pension funds; ii) Floating Funds-foreign banks. Majority of investors is from USA, UK, Continental Europe and Middle East . Investors from the developed countries are able to invest in the papers issued in the EMs due to credit enhancement and also higher yield. Notes from EMs attract higher spreads than the equivalent rated notes from developed markets . AA rated ABSs from EMs attracted 5 bp more than comparable AA paper from developed markets towards the end of December, 1997. The difference increased to 25 bp in July, 1998 due to the volatility in EMs. The higher volatility can decrease prices of underlying assets by 10 to 15%; if the structure involves 30% subordinated debt, and the prices drop by 15%, half of the cushion in the form of subordinated debt is wiped out.

Chapter 7 Special Purpose Vehicle

7.1 Concept

Securitisation offers higher quality assets to investors by virtue of the fact that the structures insulate investors from the bankruptcy risk of the Originator. In order to ensure that the assets actually achieve the bankruptcy remoteness, it is essential to move them out of the balance sheet of the Originator and park them with another independent entity. Typically an SPV is employed to purchase the assets from the Originator and issue securities against these assets. Such a structure provides a comfort to the investors that they are investing in a pool of assets which is held on their behalf only by the SPV and which is not subject to any subsequent deterioration in the credit quality of the Originator. The SPV is usually a thinly capitalised vehicle whose ownership and management are independent of the Originator. The main objective of SPV is to distinguish the instrument from the Originator.

7.2 SPVs in other Countries

7.2.1 U.S.A.

The US market, which is home to 75% or more of the global securitisation volumes, shows clear division between the MBS & ABS issuance. The MBS market has been subject to successive transformations and presently the three institutions (Fannie Mae, Freddie Mac and Ginnie Mae) act as the principal intermediaries in the market inas much as they perform the activity of purchasing mortgages from home loan Originators and selling MBS. Based upon the same, their role could be likened to those of SPVs. However, over a period of time, these institutions have matured and assumed a greater role in the secondary mortgage market. Both Freddie Mac and Fannie Mae deal overwhelmingly in pools of conventional (i.e. not Federally insured) mortgages. In sharp contrast, Ginnie Mae deals only in Federally insured mortgages. However, all three agencies guarantee their issues against default losses. Government sponsorship of Fannie Mae and Freddie Mac contributed significantly to enlarge these institutions role beyond mere conduits and helped them to become dominant institutions in the residential mortgage market. It was felt that investors would prefer to receive regular payments of principal and interest whether or not the same is collected from the Obligors even though a 100% guaranteed paper would imply lower interest yield. It thus became important for Fannie Mae and others to take on the additional role of guaranteeing the issuance being routed through them. In short, the secondary market scenario even in the most developed markets like the US is characterised by Governmental / regulatory patronage and

guarantees. Consequently the securitisation SPV in this segment of the market also displays characteristics which are typical of State facilitation and encouragement. More details of these institutions are given in Chapter 6.

7.2.2 Argentina

(a) SPVs generally take legal forms of Mutual Funds (MFs), trusts or corporations etc. According to the Trust law in Argentina, a trust (similar to SPV) is established when a person (the trustor) transfers the ownership in trust of certain assets to another person (the trustee) who must "manage" the assets for the benefit of the party specified in the trust agreement (the beneficiary), and transfer the trust property upon termination of the trust to the trustor or the beneficiary. The Trust law states that the property transferred in trust constitutes a separate estate from that of either the trustor or the trustee. *Further, the trust property is exempt from any claims of the trustee's creditors and, except in the case of fraud, the trustor's creditors. The obligations of the trust may only be satisfied from the trust property.*

(b) *The trustee is a financial institution or an entity authorised by the CNV (similar to SEBI in India) to act as financial trustee* and the beneficiaries are the holders of certificates of participation in the trust property ('certificates") or the debt instruments guaranteed by the trust property ('debt instruments").

(c) Financial trustees may be financial entities authorised under Argentine law, entities registered in the Register of Financial trustees held by CNV and the financial institutions chartered by the Central Bank of the Argentine Republic. In order to be included in the Register of Financial Trustees, an entity must be a *corporation* or, in the case of foreign company, must have a branch or other form of representation in Argentina; its legal purpose must include serving as a trustee; it must have a net worth of at least 100,000 pesos; and it must have an adequate administrative organisation to perform its duties as financial trustees, although administrative services may be contracted out.

(d) Further:

- *The trust agreement may not release the trustee or its employees from its responsibility for acts of negligence and wilful misconduct nor from the prohibition on its acquiring assets held by the trust.* Upon or after signing the trust agreement, and in accordance with its terms, the trustee will be the transferee of the assets or rights which are the subject of securitisation and as of that moment, the trustee will be endowed with title, in trust, to the rights to such principal, interest fees, collateral security etc., which title and rights may

not be challenged by third parties if the transfer and the registration are carried out in accordance with the formalities required by the applicable law.

- The portfolio of loans that may be transferred and held by a trustee will at no time be considered part of the trustee's assets for bankruptcy or other purposes.

More details are given in Chapter 6.

7.2.3 Morocco

(a) In Morocco, the SPVs can be (i) institutional investors in debt or (ii) other entities which are governed by the legislative or regulatory systems of either Morocco or other foreign countries. The SPV is a separate and autonomous body and has the capacity of a natural person. All its functions are administered by its management depository institution, akin to asset management company (AMC) in India. *It has been considered advisable that for each securitisation operation by an Originator, a separate SPV is created exclusively for that operation, although an AMC may be founder and manager of more than one SPV provided that appropriate, precautionary measures are put in place and described in the relevant administrative rules to prevent conflicts of interest and the mixing of funds.*

(b) Rules of formation of SPV

The minimum framework of rules within which the SPV is founded has been specified in the Act covering the duration of the SPV, particulars of its AMC and the financial intermediary, a description of the planned securitisation operation, nature of assets to be transferred to it, minimum and maximum amounts of intended issue, frequency and nature of mandatory information to be provided to its investors, procedures for meetings with its investors, dissolution of the SPV, etc. As a result of its exclusive purpose for securitisation operation, an SPV cannot undertake any activity or assume any responsibilities other than those prescribed in the rules of its formation.

(c) Minimum disclosure norms

The Act specifies that the rules of formation of the SPV must include the frequency and the nature of mandatory information to be provided to the investors. Any Originator holding or acquiring direct or indirect interest in the AMC must disclose the fact in the rules of the SPV and the information to be furnished to the investors. The AMCs are required to furnish a copy of the

annual report on the SPV and if required by the rules at a greater frequency, duly certified by an auditor.

(d) Separation from the assets of its Originator and AMC

The transfer of the receivables is absolute and cannot be cancelled for any reason even if the Originator becomes insolvent or enters liquidation. The receivables once transferred to the SPV are to be removed from the balance sheet of the Originator. Further, there is no guarantee from the Originator about the solvency of the debtors. All its assets are separate from those of the Originator, its management depository institution and its share/bonds holders.

(e) The SPV is required to follow the *accounting rules* approved by Government in consultation with National Accounting Council or failing this, those, which are in conformity with the accounting rules generally accepted in Morocco. The auditor has been assigned a permanent role in the auditing of the books of the SPV, verification of the consistency and the authenticity of its accounts as also the information related to its financial position prior to its being released.

7.3 SPV in the Indian context

7.3.1 In India too, Originator should have the same flexibility in choosing an appropriate legal structure for the SPV based on its individual requirements whether in form of a company, trust (with or without a company as a trustee), MF, a statutory corporation, a society, firm, etc., in short all possible forms of a business entity that is capable of being formed. 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.

7.3.2 While different forms of SPVs have evolved in various markets, Indian mortgage sector has taken cues from the US market. The securitisation SPV assumes a character different from a mere conduit in US. NHB has now taken upon itself the role similar to that being performed by Fannie Mae and Freddie Mac in the US. NHB is presently engaged in bringing to the market its pilot issue of MBS backed by mortgage pool of four Housing Finance Companies. The pilot issue has been under discussion for two years now and currently the structure and the modalities are being finalised by NHB. Based upon the experience of the issue, NHB is likely to take a longer view of what role it needs to play to give a fillip to the secondary mortgage market in India. Other players in the housing market like commercial banks, HUDCO, State housing boards etc. may also desire to participate in

the secondary mortgages market as Originator or SPV or ancillary service providers. For this segment of the market, as well as the segment relating to issuance of ABSs, certain other kinds of SPVs would develop over a period of time.

7.4 Key features desired in an ideal SPV

7.4.1 Based upon the international practices as discussed in para 7.2 above, the WG came to the conclusion that an SPV should, therefore, satisfy the following key characteristics:

(a) An SPV must be capable of acquiring, holding and disposing of assets.

(b) It would be an entity, which would undertake only the activity of asset securitisation and no other activity.

(c) An SPV must be bankruptcy remote i.e. the bankruptcy of Originator should not affect the interests of holders of instruments issued by SPV.

(d) An SPV must be bankruptcy proof. i.e. it should not be capable of being taken into bankruptcy in the event of any inability to service the securitised paper issued by it.

(e) An SPV must have an identity totally distinct from that of its promoters/ sponsors/ constituents/ shareholders. Its creditors cannot obtain satisfaction from them.

(f) The investors must have undivided interest in the underlying asset (as distinguished from an interest in the SPV which is a mere conduit).

(g) A SPV must be tax neutral i.e. there should be no additional tax liability or double taxation on the transaction on account of the SPV acting as a conduit.

(h) A SPV must have the capability of housing multiple securitisation. However, SPV must take precaution to avoid co-mingling of assets of multiple securitisation. In case of transactions involving various kinds of assets, they should restrict the rights of investors to the specific pool.

(i) The SPV agreement may not release its employees or trustees from their responsibility for acts of negligence and a wilful misconduct.

7.4.2 Instrument issued by the an SPV should have the following characteristics:

(a) Be capable of being offered to the public or private placement.

(b) Permit free or restricted transferability.

(c) Permit issuance of pass through or pay through Securities.

(d) Represent the amounts invested and the undivided interest or share in the assets (and should not constitute debt of SPV or the Originator).

(e) Be capable of being classified as senior / subordinate by differentiation in ranking

of security or in receiving payments.

(f) May be issued in bearer form or registered in the holder's name, may or may not be endorsable and may be issued in definitive form or book entry form.

7.4.3 Bankruptcy-remoteness and insolvency laws

Standard and Poor's[16] has developed the following the 'Special Purpose Entity' criteria which a SPV should satisfy to be deemed as bankruptcy-remote.:

- Restrictions on objects and powers : The purpose of this restriction is to reduce the SPV's internal risk of insolvency due to claims created by activities unrelated to the securitised assets and issuance of rated securities.
- Debt limitations: An SPV should be restricted from issuing other debt except in circumstances those are consistent with the rated issuance.
- Independent director: Interlocking directorates between he Directors of the SPV and that of its parent present a potential conflict of interest. If the parent becomes insolvent in a situation where the SPV is performing adequately, there maybe an incentive for the parent entity to voluntarily file the SPV into bankruptcy and consolidate its assets with those of the parent. If the SPV has at least one director who is independent from the parent and this director's vote is required in any board action seeking bankruptcy protection for the SPV, the SPV is unlikely to voluntarily file an insolvency petition.
- No merger or reorganisation: This requirement ensures that, while the rated securities are outstanding, the bankruptcy-remoteness of the SPV will not be undermined by nay merger or consolidation with a non-SPV or any reorganisation, dissolution, liquidation, or asset sale.
- Separateness: Separateness covenants are designed to ensure that the SPV holds itself out to the world as an independent entity, on the theory that if an entity does not act as if it had an independent existence, a court may use principles of piercing the corporate veil, alter ego, or substantive consolidation to bring the SPV and its assets into the parent's bankruptcy proceedings.
- Security interests over assets: A debt security interest opinion is generally required that the issuing SPV can grant a security interest over its assets to the holders of the rated securities. This element helps in reaching the analytic conclusion that an issuer is in fact an SPV by reducing the incentives of the parent to involuntarily file the entity. By reducing the practical benefit of insolvency filing, the likelihood of voluntary insolvency is decreased.

Each of these characteristics is important to the overall concept of bankruptcy remoteness and regardless of the specific organizational structure of the SPV, these elements should, generally, be treated in the relevant organisational documents. Such an SPV is regarded as being sufficiently protected against both voluntary and involuntary insolvency risks.

7.5 Company, Trust or MF

Reforms may be necessary in essence to establish that an SPV irrespective of its form meets the desired objectives and has the desired characteristics. While three forms of enterprise

[16] Standard & Poor's Legal Issues in rating Structured Finance transactions : April 1998, page 30.

namely, company, trust and MF have been examined in the following table, the examination is not by any means conclusive of all of the difficulties that may be encountered in the event one is desirous of utilising such business enterprise as an SPV.

Table 4: Comparative table of the desired features in a Company, Trust or MF

Sr. No.	Topic	Company*	Company as Trustee of a Trust established for securitisation*	MF [constituted as a Trust under SEBI (MF) Regulations]*
(1)	(2)	(3)	(4)	(5)
1.	Capable of acquiring, holding and disposing of assets pursuant to securitisation transactions	Yes	Yes	*The position is ambiguous and clarification may be sought from SEBI*
2.	Bankruptcy proof SPV	No - Against creditors (i.e. Debt instrument holders) - Against structural bankruptcy	Yes -Subject to suitable provisions in the Trust Deed	Yes -Subject to suitable provisions in the Trust deed and terms of issue of Units under any specific Scheme
3.	Independent corporate existence, limited liability and perpetual succession	Yes	Yes -Subject to suitable provisions in the Trust Deed	Yes -Subject to suitable provisions in the Trust Deed
4.	Tax neutrality	No	Yes -Subject to suitable provisions in the trust deed	Yes
5.	Undivided interest of investors in the underlying assets	No -as a shareholder (whether preference or equity only owner of shares of the company and of the assets	Yes -Beneficial owner of the assets	Yes -Beneficial owner of the assets (Unitholder has an undivided beneficial interest in the assets comprised in the

		of the company) -as a debt instrument holder only entitled to the repayment/payment of principal and interest		specific Scheme of the MF)
6.	Housing of multiple securitisation transactions	No	Yes -Subject to suitable provisions in the Trust Deed -The Trustee would be able to enter into different trust deeds for different transactions	Yes - MF can offer multiple schemes
7.	Capable of issuing paper of different maturities, particularly short maturity paper, publicly or privately	Yes	Yes -Subject to suitable provisions in the Trust Deed	Yes *-Clarification is however necessary from SEBI whether MFs can make private placements*
8.	SPV structures should permit issuance of both "pay through" and "pass through" securities	Yes (in case of structured debt instrument)	Yes -Subject to suitable provisions in the Trust Deed and terms of issue	Yes *Clarification is however necessary from SEBI whether two or more classes of units can be issued*
9.	Regulator	Yes - Companies as such are regulated by DCA and NBFCs are also regulated by RBI	*Could be RBI.* NBFC Regulations should not be applicable In case of public issuance of securities, would be subject to SEBI purview	Yes - MFs as such are regulated by SEBI and in case of money market MFs, SEBI and RBI play a role in regulation

* Reforms are desirable to all laws governing the respective entities in all items which renders the particular entity unable to match and meet the essential characteristics.

The pros and cons of various forms of structures for SPV are discussed below

7.6 Company as a SPV

Structuring the SPV as a Company under the Companies Act, 1956, has certain legal and regulatory issues as well as entity level taxation issues.

7.6.1 Bankruptcy Proof

A company formed under the Companies Act, 1956 cannot be bankruptcy proof since the Court under Section 433 of the Companies Act can wind it up. Under Section 434 of the Companies Act, a company shall be deemed to have been unable to pay its debts if a creditor to whom the company is indebted to the extent of Rs 500 has served a notice for payment of the sum and the company does not pay the sum payable within 3 weeks from receipt of such notice or secure the debt or compound the same to the satisfaction of the creditor.

7.6.2 The SPV will leave itself open to a winding up for non payment of a sum as little as Rs 500. Keeping in mind that one of the essential factors of an SPV established for the purpose of securitisation is that the SPV should be bankruptcy proof; a Company may not fulfil the requirement. Upon the company issuing a debt instrument or raising any money in the form of debt, the company leaves itself open to bankruptcy suits.

7.6.3 However, a Company as SPV can remain bankruptcy remote if there is true sale from Originator of SPV.

7.6.4 Instruments that can be issued by the SPV

Characteristics of instruments that can be issued by a Company are set out below:

i) **Shares :**

Shares may be equity or preference shares.

Equity Shares:

A public company set up for securitisation purposes issuing equity shares will be a single transaction vehicle. Other conditions such as transferability, stamping etc are the same as for preference shares.

Preference Shares:

Allows for the SPV to be a multiple transaction SPV. However, linking returns (i.e. dividends) to a particular asset pool might present practical problems. Also, while the Companies Act allows (by implication) differential dividends on different classes of preference shares, it is not clear whether this encompasses linking dividends on each class to different sources of profits.

Transferability and Tradability

The shares are marketable if listed. Hence, the transfer and marketability would be dependent on whether the shares are listed or unlisted. Shares can also be traded privately.

Stamp Duty on Issue

This is a State subject.

Stamp Duty on Transfer

This is a Central Subject and is charged at 0.75%.

(ii) **Debentures :**

Transferability and Tradability

The debentures are marketable if listed. Hence, the transfer and marketability would be dependent on whether the debentures are listed or unlisted. Debentures can also be traded privately.

Stamp Duty on Issue

Stamp duty is as specified by the Central Government. It is an *ad valorem* levy and the duties vary depending on the mode of transfer (whether by endorsement/ separate instrument of transfer or by delivery).

Stamp Duty on Transfer

It is a state subject.

(iii) **Other Instruments:**

To ensure that the Company is bankruptcy proof, the instrument issued by it should not impose an unconditional liability on it to repay the debt irrespective of the realisations from the underlying assets.

Tax efficiency

A Company is subject to entity level taxation and the income generated by a company is subject to tax. This would increase the cost of securitisation and the transaction would not be cost effective. The nature of the SPV is such that it merely houses the receivables and issues papers for investors. In order to achieve this and to make the paper/ instrument attractive to the ultimate investor it is important that there is no tax burden on the SPV.

7.6.5 **Recommended** Reforms for an SPV in form of a Company

- An SPV as a Company should be able to issue a new class of instrument viz. the 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 instrument should not be treated as 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. Thus multiple securitisation transactions can be handled since instruments can be issued against separate sets of assets.

- The Company should not be subject to the NBFC registration norms as specified by the RBI. *Instead, RBI may consider some other form of regulation of the SPVs.*

- In the long run, such SPV companies should be declared to be exempt from entity level taxation.

7.7 Trust of which a Company is a Trustee (Trustee Company as SPV)

7.7.1 The Trustee Company is similar to a Trust with only the role of the Trustee being undertaken by a Company. With individuals becoming increasingly averse from acting as

Trustees (as is happening in the case of MFs), a Company may act as the Trustee and issue the PTCs to the investors.

7.7.2 Characteristics of the Trustee Company

- A Company under the Companies Act, 1956 which would act as the SPV.
- It would acquire the receivables by assignment from the Originator and hold them in its capacity as Trustee.
- The Trust Deed should ensure that the Company can act as the Trustee and also hold in Trust separate tranches of receivables pertaining to different transactions
- The SPV/Trustee are not liable for the good performance of the assets.
- The administration of the SPV's assets for any transaction may be subcontracted back to the Originator or to any other servicer through an Administration Agreement describing the different tasks to be performed by the Originator (in it's capacity as Administrator).

7.7.3 *The* framework of the Trustee Company would be as in the case of a MF Trustee Company. The security issued by the SPV i.e. the PTC would not be a debt obligation of the Trustee Company. The PTCs would constitute certificates notifying ownership on the pool of the assets/receivables being securitised.

7.7.4 A PTC ideally represents a declaration of interest in a pool of assets transferable when a beneficiary changes. The Trust through the Trustees will recognise the change in the beneficiary by endorsing the PTCs. There is no transfer of ownership interest from the Trust, as it would continue to hold the securities in trust for the changing beneficiaries represented as a class.

7.7.5 The PTC would not be treated as a re-assignment of receivables as there is no transfer of property interest from the Trustee to the PTC holder. The Trustee always holds the property for the beneficiaries from inception of the Trust and never sells or reassigns the interest, as the Trust never dissolves. As there is no assignment of interest at the stage of issuance of PTC, there is no re-assignment when the PTC holder changes.

7.7.6 For each securitisation transaction routed through the Trustee company there would be a Declaration of Trust made separately for each pool of receivables. An information memorandum would be drawn up in each instance. It is similar to a MF scheme where the terms of the scheme and the benefits of the unit holders are specifically described and assigned for each scheme.

7.7.7 **Recommended** reforms for the SPV in the form of a Trustee Company

- 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.*

- Trustee owned assets would be normally treated, as distinct from company owned assets. However, a clarification from tax authorities that such SPV trustee companies would enjoy a tax shield may be necessary.

7.8 MF AS SPV

7.8.1 A MF is legally and factually a trust, being administered by a Trustee Company or a Board of Trustees, and whose assets for each scheme are managed by a separate Asset Management Company (AMC). As discussed above, while examining the trustee company concept, a MF is an existing and established legal structure, which conforms, in general, to the requirements of a securitisation SPV.

7.8.2 The schemes established by a MF are independent of one another. Separate maintenance of accounts of each scheme is required. Further, the unitholders of each scheme are owners of undivided beneficial interest in the assets of the Scheme.

7.8.3 Unless it is an assured return scheme, the Unit holders are only entitled to receive such dividends as may be declared by the AMC or the trustees. Further, in case of loss of initial investment (unit capital), the loss devolves on the investors.

7.8.4 A MF possesses most of the characteristics desirable for a securitisation SPV, namely:

- MFs are structured as trusts under the Indian Trusts Act, 1882. This gives them the flexibility to issue units under different schemes, and keep the funds raised under schemes (and consequently the rights of investors in different schemes) distinct from each other.

- MFs are permitted to issue marketable securities. While normal trusts (i.e., those that are not registered with SEBI as MFs) can borrow funds, it is unclear whether they can raise money by issuing marketable securities i.e. it has not been experimented so far.

- The income earned by MFs is exempt from tax under sec 10(23D) of the Income Tax Act, 1961.

7.9 Further recommendations for different forms of SPV

7.9.1 Company as SPV:

Applicability of NBFC Directions

If the SPV for asset securitisation is set up as a joint stock company under Companies Act, the activities undertaken by the SPV would appear similar to those of an investment or loan company and the following issues would arise. However, as explained later, the SPV in effect would only be undertaking an activity akin to trading in debt.

(i) It would require registration with RBI under Section 45-IA of the RBI Act and it should have the statutorily prescribed minimum capital funds and the present requirement is Rs. 200 lakh for a new company and this may not be possible. 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. The 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.

(ii) The SPV raises funds through issue of Pass Through Certificates or Pay Through Certificates (PTCs) and such monies may or may not be treated as public deposits. If so, the SPV would be governed by the comprehensive regulatory framework like capital adequacy requirement, credit/investment concentration norms. However, the FIs proposing to securitise their asset portfolio may transfer beneficial interest on assets in favour of the SPV, which in turn issues PTC against the backing of assets / future cash flows from these assets. Therefore, PTCs could be treated as a secured instrument and the NBFC Directions should not be applicable. The debentures/bonds, which are fully secured by the assets of the company in respect of which a charge has been created in favour of the trustees for such debenture holders/bond holders, are exempted from the description of public deposits. On the other hand, if the PTCs were treated as near to equity, the NBFC Directions would not cover them because raising of money by contribution to capital is exempt from the definition of deposit.

(iii) If the SPV company is floated by an NBFC as the Originator, it could be reckoned as a company in the same group or its subsidiary and the Net Owned Fund of the Originator NBFC would be severely affected because of the exposure to the group companies. The SPVs promoted for infrastructure development are presently facing the same difficulties. This is a larger issue and the Originators should have an arm length relationship with the SPVs promoted by them and should not have more than the substantial interest. Alternatively, in order to give encouragement to the NBFCs to promote SPVs for the purpose of asset securitisation, RBI would also need to clarify that such SPVs will not be treated as the companies/entities in the same

group/subsidiaries of the Originator NBFC because it would have no beneficial interest in the SPV except to the extent of its shareholding or the investments made in the instruments issued by the SPV. It would encourage the NBFCs to promote the SPVs without an adverse impact on their Net Owned Fund.

(iv) If the SPV company were promoted by a bank, it would require prior approval of RBI under the B. R. Act, 1949 for investing more than 30 percent of the paid up capital of the bank or the investee company. The banks could, however, own less than 30 per cent of the equity of the SPV and float the company in association with other financial institutions.

7.9.2 Trust as SPV:

An option that could be examined is the exercise of inherent powers of the Government of India under the Constitution of India and the Government of India Act, 1935, to notify a requisite scheme (akin to the SEBI (MF) Regulations, 1996, under which securitised paper can be issued by a trust established for the purposes of securitisation. Similar steps have been taken in the past by the Government of India, e.g., the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (through Depository Receipts Mechanism) Scheme, 1993. The Government of India could under such scheme/regulations (for issue of securitised debt receipts through the securitisation fund) designate an appropriate authority for administration of the scheme/regulations.

7.9.3 MF as SPV

The MF in its current form, however, cannot be used to perform the role of a securitisation SPV due to the following reasons:

- A MF cannot buy into assets and actionable claims. The entire SEBI (MF) Regulations mention only 'security' – whether it is in the context of the role of the AMC or in the accounting and valuations aspects.

- The existing set of regulations includes, to a large extent, directives that are vital to normal MFs but redundant as far as securitisation SPVs are concerned. The amendment of every clause of the existing regulations to encompass all the activities of the SPV would be a laborious task since the entire spirit and focus of the MF regulations is on regulating activities very different in nature from that of a securitisation SPV. Re-writing a fresh set of regulations for securitisation might prove to be less cumbersome and easier to understand.

7.9.4 Unincorporated bodies (Partnership firm/ society, etc. as SPV - applicability of NBFC guidelines

(a) In view of the fact that securitisation is a financial activity, the unincorporated body (i.e., individual, firm, HUF, association of persons) undertaking such activity would be deemed to be engaged in financial business and the provisions of Chapter III C of the Reserve Bank of India Act, 1934 would be attracted to such activities. The unincorporated entity is, *inter alia,* not allowed to raise deposits from other than the relatives and institutions specified in the Reserve Bank of India Act, 1934.

(b) The bonds, debentures or any other instruments near to equity can be raised only by joint stock companies. The unincorporated entities can, therefore, issue only the PTCs. In so far as they issue PTCs to the specified institutions, *viz.*, FIs, statutory corporations, cooperative societies, companies incorporated under the Companies Act 1956 etc., these borrowings or moneys received through issue of PTCs would be exempt from the purview of 'deposits' and to that extent these entities could act, unhindered, as SPV for issuing securitised papers. In the usual course, initially, the investors are the institutions or corporates only, and the provisions of Chapter III C of the Reserve Bank of India Act, 1934 would not be attracted. There could, however, be instances of unincorporated entities acquiring the PTCs by their purchase in the secondary market. The situation emanating therefrom could be unintended by the issuers and could be an aberration. These should therefore be ignored for the purpose of compliance with the Reserve Bank of India Act, 1934.

(c) There are no regulations on the unincorporated bodies investing in the securitised papers. They can acquire hold, transfer, purchase, repurchase etc., in the usual course of their business and subject to the compliance to the other applicable statutes.

The observations will also apply to SPV as a Trust or MF.

7.9.5 Further, the Working Group discussed whether SPV should be one time entity (transaction specific) or an on-going entity. It was also suggested that a few SPVs might cater to the needs of particular industry and thus acquire specialisation in securitising assets pertaining to a given sector of economy. Another view was that the co-mingling of asset pools from various Originators might not be an appropriate strategy till the system stabilises. The day to day functions of SPV may be performed by an administrator / servicer for a fee.

7.10 Conclusion

7.10.1 The fact remains that the MF is 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 be prevailed upon to frame a suitable set of guidelines for regulating the securitisation activity on the lines of the MF Regulations.*** A point to note is the recent issuance of Guidelines for collective investment schemes, which again have many aspects in common with securitisation schemes. SEBI's experience in handling similar legal structures involving aggregation of investments (public or private) would help the activity arrive in market in a regulated form.

7.10.2 While the SPV would be incorporated & registered as an entity under its parent legislation, for e.g., a company would be registered with the Registrar o companies; for such a Company to engage in the activity of public issuance of securities, it may be desirable for the entity to be registered with the capital market regulator also. This may be kept in view by SEBI while framing the guidelines for regulating the securitisation activity.

7.10.3 For securitisation to realise its true potential in the infrastructure / housing and other capital deficient sectors, widespread participation in securitisation schemes is highly desirable and should be encouraged. SPV should therefore be capable of issuance of securities to a large variety of investors. The concerns relating to investor protection will be adequately taken care of by the capital market regulator.

7.10.4 Since investor participation in securitised paper will be from both the private placement markets as well as by public issuance, it is desirable that both the activities are regulated from a common point. This is particularly so in view of:

- Common set of guidelines which will rule out duplicity of regulations.
- The informed investor i.e. FIs/mutual funds, etc. will help the activity take off initially by subscribing to the scheme. Other investors like pension funds, insurance companies, etc can gain confidence and participate through the secondary market.
- Likely widening of the potential investor base right from inception in view of the above.

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.

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.

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 economies 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

1. 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 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, if 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.[17]

B. A PFI can also divulge information relating to its constituents if it is required by law or practice or usage customary to bankers.[18]

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[17] Section 3 (2) of the Act.
[18] Section 3(1) of the Act

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

Securitised 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 securitised 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.

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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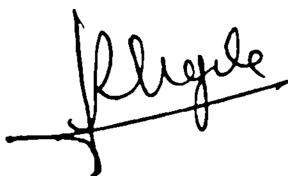
V.S.N. MURTY
(Chairman)

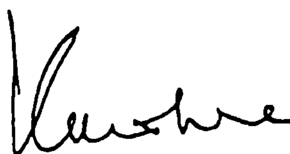


S. R. HEGDE
(Member)

A.S. RAO
(Member)

RAJESH VERMA
(Member)

S.D. SAPKAL
(Member)



K.K. VOHRA
(Member-Secretary)

Annexure – I

(see para 1.4, 10.2.1, 10.2.2.7)

Presentations given by outside organisations to the In-house Working Group

SBI Capital Markets Ltd.

1. Smt. Rupa Devi Singh, Vice President & Group Head, Financial Engineering, SBI Caps gave a detailed presentation covering the Indian experience in contrast to the ground realities in some of the developed countries. The various hindrances faced by SBI Caps in their attempt to structuring securitisation deals were explained at length. She stated that officials from SBI Caps along with NHB had visited USA in 1994 to get a feel of the securitisation process and interact with various agencies engaged in securitisation. She explained the intricacies pertaining to treatment of receipts as equity by the Originator out of the sale proceeds. She stated that there were difficulties in creating a trust as the existing legal and other environment are not conducive for trusts to come into being. She also informed the Group that Ashok Leyland and Tata Finance were active in this field among NBFCs. She stressed the importance of securitisation as this instrument is destined to play a leading role in funding long term assets of say, 15 years maturity. She informed the Group that Institute of Chartered Accountants of India (ICAI) are yet to issue suitable guidelines for securitisation although SBI has already written to them. She explained the difference between Pass Through Certificate and Pay Through Certificate. She pointed out that while an umbrella legislation could be considered in the long run, minor amendments to some legislation and issuance of clarifications for the present, will facilitate the promotion of securitisation in the short run.

National Housing Bank (NHB)

2. Shri R.V. Verma, General Manager, NHB informed the Group that NHB has acquired vast experience in mortgage securitisation in recent years and has reached an advanced stage of preparation for launching the securitisation product in a big way. Shri Verma spoke on securitisation of mortgage loans and operational and regulatory issues. He informed the Group the huge funds requirements (Rs.1,50,000 crores during current five year plan) and the constraint of the meeting these requirements through either budgetary allocation of Government or normal credit flow of the banking sector. He stated that

housing finance institutions have reached a stage where they can go direct to the market without the intermediation of banking institutions. He explained how supply of funds to the mortgage market through securitisation could lower the interest rates on mortgage loans. Long term debt market can be facilitated through introduction of mortgage backed securities (MBS). He explained how the regulatory, promotional and financial roles of NHB are mutually synergic. While the regulatory role gives an opportunity to have on site supervision and off-site surveillance, the information can be gainfully utilised to promote research, analysis of past performance and the behaviour of various classes of mortgage loans. These can lower the yield on securitisation paper and increase the spreads. He suggested that a beginning could be made by securitising loans of individual housing finance companies followed by pooling of portfolio of different housing finance companies. He informed that Ninth Five Year Plan had indicated resources mobilisation to the extent of Rs.2,500 crores through securitisation. There is growing gap between the demand and supply of houses. The current environment of deregulation can be capitalised upon by introduction of an active secondary mortgage market. NHB had taken up the matter of securitisation with State Governments through Ministry of Urban Development. Simplified foreclosure laws are attracting the attention of the Government. This, coupled with mortgage insurance can improve the competitiveness of securitised instrument. Through securitisation, funds can be channeled into housing sector through MBS. He also impressed upon the need of implicit guarantee of the Government to the MBS issue of NHB. He indicated that 'cherry picking' would be required in the beginning. This may give incentive for quality portfolios, standardised documentation etc. He pointed out the need of adequate disclosures in the offer document regarding the items/ rights where recourse is available and items/ rights where recourse is not available. He also highlighted the pool selection criteria evolved by rating agencies in association with NHB which included unencumbered loans, lending to individual for residential houses only in the State of Maharashtra, Tamil Nadu, Gujarat and Karnataka with maximum loans to value (LTV) of 80 per cent. Joint loans with other lending institutions are to be excluded. The recourse to the Originator in the form of cash flow is limited to the cash pool set aside for these purposes by the Originator. He highlighted that pre-payment risk and default rik beyond credit enhancement in Pass Through Certificates will have to be borne by the investor. He also suggested that investment in MBS by banks should be (i) treated as priority sector lending, (ii) included in

the allocation of the banks for housing finance and (iii) given 20% risk weight as in the case of investment of bonds of NHB.

ICRA Ltd. (ICRA)

3. Shri Naresh Takkar and Shri Basu of ICRA gave the presentation on 'Structuring and Assessment of Credit Risk of receivables – System requirements'. The presentation covered the assessment of credit quality risk, structural and legal regulatory issues and system requirements from Originator point of view. The rating measures ability and willingness of the structure to sustain all repayment obligations (cash flows) over the currency of the transaction. Shri Basu explained the difference between traditional MBS/ABS, Collateralised Debt Obligations (CDO) and future receivables. In India, recent innovations include housing finance receivables, electricity receivables, school fees, future collections by builders, ticketing receivables by Air India etc. Large issues are not rated and are placed privately under bilateral arrangements. Shri Basu informed that there are Standby Administrators and Standby Trustees in the USA, which can be inducted if investors feel so. Credit enhancement bridges shortfalls in cash flows from time to time. He also pointed out that SPV could be tax neutral in case of Pass Through Certificates and tax assessable in case of Pay Through Certificates. In the process of risk assessment, the rating agencies undertake actuarial exercises to ascertain the probability of default. In the Indian scenario, very little information is available on the demographic characteristics of the pool of assets except for the data on income level of Obligors. Different geographical locations can have influence on the actuarial assessment (better quality assets in western and northern zones while the assets in southern part of the country have erratic behaviour). The nature of asset (e.g. ordinary / luxury car, heavy duty / light duty vehicle) also influences the level of credit enhancement. Credit enhancement is linked to targeted credit rating, which need not be 'AAA' in all the cases. In the payment mechanism, the Obligors make payments to the Originators even after securitisation. The re-investment risk in pay through structure can be minimised through investment in safe Government of India securities instead of securities of State Government / municipal bonds. In the case of third party guarantees, the credit risk is to be evaluated. In case of the floating rate instrument, benchmark rate and frequency of monitoring are important structure issues. The clarity of the definition of the roles of Originator, SPV and Servicer are other important determinants. He also elaborated the SPV structure in the form

of Corporate or a Trustee. In the case of a Trust, although it is easier to create the entity, the investors have the right to seek even the minutest details of the underlying Obligors. He also stated that the nature of issue Pass Through Certificate, bonds or debentures is a grey area. He also informed that there was a ceiling of 10 per cent credit enhancement in USA till recently. On the subject of other legal and regulatory issues, Shri Basu opined that the notification to the Obligor is not required under the Indian laws. He also stated that call option for Originator (repurchase obligation of the Originator) is not allowed.

ICICI Ltd. (ICICI)

4. A team of four officers from ICICI gave the presentation on 'Securitisation: Steps to be taken to initiate the instrument in India'. The presentation included assignment process, the structure of SPV, nature of securitised instruments and other issues. It was explained how Order II, Rule 2 of Code of Civil Procedure 1908 prohibits part assignment. Section 5 of Transfer of Property Act, 1882 states that the property being transferred must exist in present and prevents transfer of future receivable. Further, the high stamp duty ranging from 4 to 10 per cent in many States also needs to be exempted/ minimised for securitisation transactions. Under the Income tax Act (Section 60) transfer of income without transfer of underlying assets keeps Originator liable to taxation. Section 63 of the Income Tax Act, involving transfer of beneficial interest without transfer of legal interest, makes transferors liable to taxation. Section 10 (23G), which gives benefit of investment in infrastructure bonds, should be made applicable to securitisation debts representing loans for infrastructure developments. Regarding SPV, it was stated that it should achieve –

- Bankruptcy remoteness
- Tax efficiency
- Capability to issue publicly traded paper

Out of the various forms of SPV as Company, Trustee and Mutual Funds (which is not subject to taxation), the Mutual Fund (MF) is most suitable immediate remedy. A point was raised whether MFs can issue securities with assured returns. This may have to be examined in detail at a later stage. It was also pointed out that Regulation 43 of SEBI (Mutual Fund) Regulations 1996, needs clear definition of securitised debt. Second proviso of Regulation 43 ibid excludes investment by MFs in MBSs. This needs to be deleted. It was opined that banks and MFs might be initial bulk investors in securities debt as they are well informed of

the intricacies of financial innovations. It was suggested that working capital agreement between the financial institution and the borrower may exclude all receivables (which the financial institutions may acquire in due course of time) to be charged to the bank. The treatment of exposure to Originator or Obligator should be made clearer. Treatment of up front income (difference between the yield earned on loans securitised and coupon rate for securitised debt over the tenure of the loan) should also be clarified. It was suggested that (i) RBI should issue clarifications to banks for issuance of NOCs within the definite time frame (as was done for Factoring), (ii) RBI should clarify that on securitisation deals, exposure will be on Obligors and (iii) Concessional finance should continue to be made available in the event of export receivable securitisation.

ILFS

5. The presentation by the ILFS on the subject of 'Infrastructure Financing and Securitisation' emphasised two major benefits of securitisation (i) cost of funding will be reduced (ii) larger number of investors can be approached for meeting the infrastructure needs. The presentation gave a background on infrastructure financing, securitisation in infrastructure financing and constraints in securitisation. The nature of funds utilised for infrastructure (ports, roads, power projects, water and sewage etc.) development was highlighted with the need to perceive risk involved at pre-commissioning and post-commissioning stages. It was pointed out that only a few institutions understand infrastructure risks.

Citi Bank

6. The bank is involved in securitisation since 1990. Shri Jayakumar emphasised the need of reducing the transaction cost and the creation of quality assets to develop securitisation in a significant way. He suggested that (i) in the short run, some guidelines can be framed to facilitate securitisation, (ii) in the long run, nodal agencies like NHB may undertake the activity of market maker by shifting from the role of refinancing in a phased manner. He opined that UK model is appropriate for Indian conditions. The trading in securitisation needs to be operationalised as some of the securitised debt in the past, although listed on the National Stock Exchange, was not traded. He also emphasised that structure / role of different agencies should be considered on a different footing from the issue of tax exemption. Reserve Bank of India (Department of Banking Operations and

Development) may make uniform guidelines for investment in direct mortgage backed securities and asset backed securities. Shri Jayakumar also stated that the latest consultative paper of Bank for International Settlement, which gives lower risk weights for highest rated debt, might encourage high graded instruments in the area of securitisation.

Duff & Phelps Credit Rating India Pvt. Ltd. (DCR India)

7. Shri N.C. Roy, M.D., DCR India highlighted the relevance of the rating process in securitisation deals. He averred that the 'informed' investors will alone be deploying their funds on securitised papers and hence pointed out the need for transparency and information sharing of a high degree. This was followed by a detailed presentation by Shri A. Bhoumik of DCR India. He referred to the need of a guarantee company, as was the case with mortgaged loans in U.S.A. He stated that the support of guarantee companies could be considered towards extending credit enhancements especially for the infrastructure sector. Different future flow risks like product risk, obligor risk, etc. were highlighted. Referring to their past experiences, he stated that there had been no instance of default in the case of 117 international issuance on securitisation transactions rated by DCR between 1991-98 despite melt-downs in some of the emerging economies. The Group was informed that securitisation had survived economic downturn in Mexico during the Tequila Crisis of Mexico during 1995. Securitisation had also survived corporate default in Venezuela, Pakistan and Indonesia. In the case of India, there is good scope for securitisation of future flows of oil and gas receivables, credit card vouchers receivables and tolls / rentals / service contracts / fees, etc. As a part of the rating methodology, he averred that DCR assesses the legal and payment structure, track record of the management, MIS irrespective of the originator or investors. He explained that due diligence process followed by them is exhaustive which includes assessment of origination / underwriting policies, random sampling, documentation, etc. Credit enhancement is determined by worst case scenario, review of concentration issues, etc. The rating rationale gives transaction details such as the Originators, tenors, security, legal issues, pool characteristics, sensitivity analysis, cash flow statements (which influences the AAA or other ratings), etc. The periodic service reports include pool behaviour, delinquencies, etc. Drawing upon the experience of a live deal, he brought out the importance of backup services especially in the case of bankruptcy of the

Originator. The issues like filing of suits by receiving and paying agents and pass through nature of SPV were the other issues highlighted during the presentation.

Credit Rating Information Services of India Ltd. (CRISIL)

8. Shri D. Thyagarajan informed the Group that CRISIL had pioneered securitisation rating in India in 1991 and has rated about 50 securitisation transactions with volume aggregating to well over Rs. 4,500 crore. Various forms of credit enhancements used include cash collateral, over-collaterisation, spread account and guarantee. He pointed out that there has been no instance of downgrading of rating in securitisation transactions. There has also been fairly accurate prediction of pool performances. CRISIL engages legal experts during the process of finalisation of transactions. The feasibility of issuing asset backed securities in demat form to save on stamp duty and minimise documentation was also highlighted. The issues regarding interest tax (the treatment of interest gain to the Originator as one time revenue gain or a continuous flow of gains over the tenor of the asset) and tax deducted at source were also highlighted. He pointed out that there was no separate legislation on hire purchase or leasing transactions. He suggested that the rights of the lessors in documentation need to be clarified in Motor Vehicle Act. A view was expressed that it may be helpful if the ownership / endorsements in the books (Registration Books in the case of securitisation of motor vehicles) are in the name of SPV in the records of Transport Authorities. The need to create awareness about the securitised instrument among the investors especially pension funds, banks, etc.) was emphasised. The regulators may prescribe investments by various institutions based on the rating of the securitised instruments. There is a greater need for rating in case of securitised paper vis-à-vis a conventional debt paper in view of the complexity of the structure involved and the fact that only a pool of assets back the paper, without backing of any entity. Private placement may also need to be rated. He suggested that the offer documents may disclose (i) all risks, and (ii) the ratings assigned besides the rating rationale. Originator's annual report may disclose the securitisation kept off the Balance Sheets, extent and form of credit enhancement provided by the Originators and the potential liability therefrom. There is a need for accounting guidelines to be issued for originators, investors and SPVs. Some of the rating issues, which prevent the delinking of Originators' risks, are

- Commingling of cash flows,

- Lack of third-party services,
- Borrowers not used to making payments to parties other than the original lender, and
- Efficacy of third party services not tested out.

Due to these problems, CRISIL is not in a position to sign rating based only on quality of assets. There is also lack of legal case history to know how courts would view securitisation transaction in the event of the bankruptcy of the Originator.

Consultant, Asian Development Bank (Shri S.P. Ghosh)

9. Shri S.P. Ghosh gave a presentation on 'Opportunities for the development and growth of Asset Securitisation'. Shri Ghosh was a member of the team of 13 experts, which visited U.S.A. during 1995 to learn lessons from their securitisation experience. He highlighted the benefits of securitisation in a capital scarce economy like India. Securitisation helps in allocation of risk to the best owner. Non-credit risks are also measured and covered. It ensures direct reward for better credit quality and facilitates standardisation of industrial practices. Securitisation in India has to focus on greater communication between the Originator on the one hand and the auditors, rating agencies, investors, due diligence agencies, etc on the other. There is a need for the regulators to promote securitisation. He made a reference to the introduction of tax incentives in U.S.A. during 1981 by way of (i) loss allocation over residual life of assets; (ii) loss set off against past filing. From 1977 to 1999, assets worth trillions of dollars have been sold without default, loans have become cheaper and the regulators including U.S. Treasury are showing quick response to market responses in U.S.A. Shri Ghosh dwelled upon the focus areas for RBI. These included building of wide consensus on benefits of securitisation and encouragement of market development. Drawing from his experience in German market, where he had spent 6 months, Shri Ghosh referred to the nascent stage of securitisation during 1989-90, which culminated into the current matured stage of securitisation in a gradual way. He referred to the need of building skills in the area through different training institutions of RBI, seminars etc. Another suggestion was to reduce the risk weights in the securitised instrument to a level of around 20 per cent. He emphasised the need of high disclosure standards, which should be made mandatory. Specific sectors like housing and infrastructure should be focussed especially in view of the increasing role of HUDCO in urban infrastructure. For this purpose enabling institutions may be set up. Shri Ghosh

referred to the need of specific notification to the institutional investors - banks, FIs and NBFCs. Individuals / retail investors may be targeted at a later stage. On the issue of SPV, he averred that SPV should only be a conduit having credible board and trustee character. Alternate structure in the form of MF, Trust, or Company should be allowed but all SPVs should be registered with RBI. There should be a separate chapter on SPV in RBI Act stipulating minimum capital, prudential norms, etc. SPV may not be treated as NBFC as monies held in Trust by SPV for investors are not deemed to be public deposits. As a conduit, SPV should be considered neither a borrower (S 58A) nor a lender (S 372 A). Speaking on the regulatory changes, he suggested amendments to Section 27 A & B of Insurance Act, 1938 to include securitised papers through a Notification by GOI. The guidelines should specify the capability of the organisation to handle the complex transaction before venturing into securitisation. This should include financial control, monthly reporting, audit co-ordination, pool extraction, portfolio MIS, systems upgradation and treasury skills (structuring, pricing, placement, etc.) The presentation ended with recommendations for amendments to RBI Act to allow for SPVs, clarification on money held by SPVs, inclusion of asset-backed securities in priority sector lending depending upon underlying receivables etc. The disclosure document should include the information on assets' historical performance, cash flow elements and appropriation, investment consideration and risk factors, legal and tax structure, seller's business etc. There should be sufficient due diligence by auditors. As investors, the exposure should be treated against the asset class and not against the issuer or the instrument. Certain nodal institutions (infrastructure, housing, etc.) should be reoriented. Shri Ghosh emphasised the need to rewrite the laws. He referred to the compendium on transfer of property prepared by him during early 1998, which encompasses nine laws (four central and five state laws). One of the members expressed the concern that the current securitisation transactions may not be complying with all the legal requirements. Finally, Shri Ghosh emphasised the need for reporting the securitised transaction in RBI Bulletin / Website.

ANZ Investment Bank

10. Shri Kanti Shah and Ms. Geetika Hatangadi gave a presentation on 'Securitisation in the Australian Market'. Government sponsored mortgage programme was initiated in Australia during mid 1980s. Reserve Bank of Australia released prudential guidelines for

securitisation during 1995. Banks and their subsidiaries have the largest pool of assets, which can be securitised. Australia has well defined foreclosure laws. Any mortgage loan with more than 80 per cent of loan to value (LTV) is backed by insurance. The securitised instrument ranges from tenure of 30 days (commercial paper) to MBS bond with a legal life of 30 years. There is a clear separation between the Originator and SPV; an Originator cannot own or control the SPV. The credit enhancement facility is limited in amount and time frame. Regarding the SPV structure, there is a complete tax exemption in case of trusts. In the case of corporate, the tax exemption is given in case the inflow and outflows are matching. During 1998, the share of offshore issues increased significantly compared with the domestic issues.

Annexure – II

(see para 4.5, 8.1.3 & 9.8 & 10.2.4))

Accounting Treatment

Approaches to accounting treatment for securitisation

1. There are broadly two approaches to accounting treatment for securitisation, namely,

   (i) `Indivisible unit approach', according to which the Originator accounts for the securitised assets which are considered to be transferred as indivisible units that are either entirely sold or entirely retained.

   (ii) `Financial components approach' which recognizes that securitised assets can be divided into a variety of components. For example, a loan portfolio, which is securitised may give rise to a servicing asset and an interest-only strip receivable etc., apart from the loan asset which is transferred. Thus, as per this approach, a component of the securitised asset may be sold, while the other components are retained by the Originator and, therefore, treated as separate assets.

2. It appears that the Financial Reporting Standard (FRS) 5 on `Reporting the Substance of Transactions' (issued in April 1994 in U.K.) broadly follows the first approach, i.e., the financial assets are considered to be transferred as indivisible units. On the other hand, the Statement on Financial Accounting Standard (SFAS) 125, on `Financial Instruments: Transfers', issued by the Financial Accounting Standards Board (FASB) in USA follows the financial components approach. The International Accounting Standard (IAS) 39 on `Financial Instruments: Recognition and Measurement' is broadly in accordance with the SFAS 125, i.e., it also follows the financial components approach.

3. The financial components approach requires that all assets obtained and liabilities incurred in consideration of the securitised assets should be recorded at fair values (where it is not practicable to estimate the fair value, the same is required to be taken at zero).

4. In India, at present, the generally accepted accounting principles, including the Accounting Standards issued by the Institute of Chartered Accountants of India, are primarily based on historical cost convention. In other words, the fair values are generally not recognized as the basis for valuation of assets and liabilities. One of the factors which hinders adoption of fair value as the basis of valuation is the non-availability of fair values of various assets because of lack of relevant markets.

5. In India, the securitisation of assets is still in infancy. Thus, the innovations of various financial components of securitised assets in the financial markets may not be impending. Accordingly, the financial components approach may not be relevant at present.

6. At present, in India, the basic issue with regard to accounting for securitisation is: Whether the securitised assets should be considered as an off-balance sheet item or not, rather than the esoteric issue of fair value basis for valuation of assets.

7. In view of the above, it appears that the approach adopted by FRS 5 in UK, i.e., indivisible asset approach, would be more relevant in the Indian situation. In any case, since the Research Committee of the Institute of Chartered Accountants of India (ICAI) is bringing out a Guidance Note on the subject, the approach to be followed in this regard would have to be decided by the Committee and thereafter approved by the Council of the Institute.

Accounting Treatment for Securitisation

8. Under both the above approaches to accounting for securitisation, the central issue is when can the securitised assets be removed from the balance sheet of the Originator. This issue is to be decided by answering the following two questions:

   (i) Whether the Originator has access to the **benefits** of the securitised assets and exposure to the risks inherent in those benefits; in other words, whether all significant risks and benefits in the securitised assets have been transferred by the Originator, and

(ii) Whether the Originator has a **liability** to repay the proceeds of the notes issue.

As per SFAS 125, the basis for removal from the balance sheet of the Originator is whether he has surrendered control over the securitised assets.

9. An issue arises as to which criteria should be adopted to decide whether significant risks and benefits have been transferred (or control has been surrendered) on the securitised assets. The conditions laid down in SFAS 125 are more detailed and appear to be more stringent. IAS 39 while providing for surrender of control, only gives illustrations of situations under which control can be considered to be lost. FRS 5 provides indicative criteria (Annexure `A') for deciding whether all significant risks and benefits in the securitised assets have been transferred. In resolving the issue of the criteria to be adopted, it is felt that in India, FRS 5 may be appropriate due to following reasons:

   (i) The criteria of transfer of risks and benefits would be more readily understood as the present generally accepted accounting principles are based on `transfer of risks and rewards of ownership' (e.g., in AS 9 on `Revenue Recognition') while resolving the issue of `substance over form'.

   (ii) SFAS criteria for surrender of control are too detailed, complicated and, therefore, may be too cumbersome to apply.

   The Research Committee of the ICAI may, however, consider prescribing specific criteria for deciding when significant risks and benefits in the securitised are transferred.

10. As per FRS 5 where the Originator has transferred all **significant benefits and risks relating to the securitised assets and has no obligation to repay the proceeds** of the note issue, derecognition, i.e., removal of the securitised assets from the balance sheet of the Originator is appropriate. On the other hand, where the Originator has retained significant benefits and risks relating to the securitised assets from the balance sheet, it is not appropriate to derecognise the securitised assets from the

balance sheet, but an asset equal in amount to the amount of securitised assets is shown on the balance sheet of the Originator, i.e., it is not treated as an off-balance sheet item.

11. In practice, the Originator retains some benefits such as interest-only strip receivable or offer to perform some service related to the securitised asset, e.g., servicing of loans in return of some fee, providing liquidity to issuer in return of a fee etc., or there is a limited recourse obligation. As per SFAS 125, while it is possible that the Originator surrenders control over the basic securitised asset, say, a loan, and, therefore, it qualifies to be recognized as a **sale (derecognition),** he may retain certain rights such as interest-only strip receivable and a service asset, which are recognized as assets valued on the basis of fair values. FRS 5 in the Application Note on Securitised Assets does not appear to prescribe such recognition of assets. In other words, as per FRS 5, it appears that the retention of rights and obligations of the aforesaid nature have to be considered in deciding whether significant risks and benefits in the securitised asset have been transferred and, then, on that basis, the `entire asset' is derecognized or continued to be recognized (`indivisible asset' approach). However, FRS 5 recognizes that there could be situations whereby even though significant risks and benefits relevant to the securitised assets have been retained by the Originator but there is absolutely no doubt that its downside exposure to loss is limited. In such a situation, the Standard requires that a linked presentation should be used, i.e., the proceeds of the note issue to the extent they are not returnable should be shown deducted on the face of the balance sheet within a single asset caption. The Standard also requires various disclosures to be given in case of linked presentation.

12. The following are some examples of the accounting treatments of asset securitisation in different situations:

    (i) An entity 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' in the books of the Originator.

The following journal entry may be passed:

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

(Being debtors of Rs. 100 transferred for a consideration of Rs. 100 under securitisation arrangement with M/s. _________)

(ii) An entity transfers, in a securitisation arrangement, a portfolio of Rs. 100 in consideration of Rs. 100 and a third party, say a bank, provides guarantee, to the Issuer. In the event the securitised assets are not realised by the Issuer, the bank pays the same to the Issuer. In case the bank does not have recourse to the Originator, in return of a fee, it may be said that all significant risks and benefits in the securitised assets have been transferred. In such a situation also, the asset will be derecognised.

The journal entry will be the same as in (i) above in the books of Originator. In the books of the third party (credit enhancer), the following entry may be passed :

Profit & Loss Account Dr.
To Cash / Bank A/c.

(being entry to record the invoking of collateral on transaction with M/s._________)

(iii) 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 whose amount depends on whether and when debtors pay. In addition, there is recourse to the entity for the first Rs. 10 of any losses. Assuming the conditions for linked presentation as laid down in FRS 5 are met, 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

(Being the amount of expected bad debts provided for against the debtors of Rs. 100)

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

(Being Rs. 95 received under the securitisation arrangement for debts and liability of Rs. 10 created in respect of recourse)

Securitisation of over-collateralised asset: Accounting at the time of selling the asset as well as at the time it flows back or in the event it does not flow back

13. In this situation, the assets transferred are in excess of the amount of consideration received by the Originator. The objective of transferring this excess is to provide security to the Issuer as the excess can be used by the Issuer in the event the securitised assets are not fully realised by the Issuer to the extent of the consideration paid to the Originator.

14. In the above situation, all risks and rewards are not transferred to the Issuer. If the amount received as a consideration is non-refundable, i.e., it is absolutely certain that this amount will not be returned to the Issuer, it may be appropriate to disclose the transaction as a linked presentation as suggested in FRS 5. *Thus, 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.* In case the Issuer uses these receivables, then these should be removed from the balance sheet and the loss to that extent be recognized in the profit and loss account of the period concerned. Where the Issuer

reaches a situation under which he does not have to exercise recourse to the excess, the receivable would continue to be disclosed as a normal receivable. *In the books of the Issuer, the securitised receivables received should be shown to the extent of consideration received, i.e., the receivables received as a over-collateral should not be disclosed on the face of the balance sheet, but may be shown as a note to the accounts explaining the nature thereof.*

Revolving Period Securitisation

15. On a perusal of FRS 5 and SFAS 125, it appears from the accounting point of view, that the securitisation can be in respect of existing assets. For instance, para 52 of SFAS 125, related to `Revolving Period Securitisations (i.e., securitisation of certain types of receivables, say, credit card receivables, existing as well as to be received over a future specified period) states as below:

> "Gains or loss recognition for revolving period receivables sold to a securitisation trust is limited to receivables that exist and have been sold. Recognition of servicing assets or liabilities for revolving period receivables is similarly limited to the servicing for the receivables that exist and have been transferred. As new receivables are sold, rights to service them become assets or liabilities and are recognized."

In view of the above, *it appears that 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.*

The following illustration would explain the amounting treatment:

An entity securitises 5 year future export sales for a consideration of Rs.100. Each year sales is Rs.20 for next 5 years. The following entries may be passed in securitisation :

Cash / Bank A/c. Dr.	Rs.	100
To Export Sales Securitisation A/c.	Rs.	100
(being 5 year export sale securitised with M/s. ______________________)		

The Export Sales Securitisation Account would be shown on the liabilities side of the Balance Sheet. In year in which Export Sale take place the following entry may be passed.

Export Sales Securitisation A/c.	Dr.	Rs.	20
To Export Sales A/c.		Rs.	20
(being Export Sales of the year accounted)			

The Export Sales securitisation A/c. would be reduced to Rs.80 and shown on liabilities side of Balance Sheet. The Export Sales A/c. would be credited to Profit & Loss Account of the year.

Disclosures

16. The disclosure requirements would depend upon the method of accounting finally decided by the Research Committee of ICAI. However, in general, the following disclosures may be made:

    (a) the accounting policies followed,

    (b) the characteristics of securitisations, 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.

17. As discussed earlier, in India, perhaps the FRS approach may be more appropriate. A summary of three types of accounting treatments, namely, derecognition, linked presentation and separate presentation as per FRS 5 are given in Appendix 'A'.

18. 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 e.g. on the facts given in

para 12(i), the following entry would be passed :

Debtors A/c. Dr.

To Cash / Bank A/c.

Issuer (SPV) may maintain balance-sheet of its own.

Valuation of Investments in Loan Notes by Noteholders

19. Another issue, which may be of relevance, is how the noteholders would value their investments in the loan notes, keeping in view the fact that there may be certain peculiar features in respect thereof. For example, the notes may be redeemed by the issuer in installments based on the receipts from the securitised loans, the amounts and the timings of which may or may not be reasonably certain. It is, therefore, argued that such notes may be valued on the basis of the net present value of the expected net cash inflows over the period of the investments. In this context, it may be noted that at present also some securities exist which provide for periodical piecemeal redemption. It is submitted that such securities are presently valued as per the requirements of Accounting Standard (AS) 13, `Accounting for Investments', issued by the Institute of Chartered Accountants of India. The said standard does not exempt securities of the nature of loan notes issued under a scheme of securitisation. *Thus, it appears that the loan notes should also be valued at cost, if investment therein is considered of long term nature and at the lower of cost and fair value if they are in the nature of current investments, as per the requirements of AS 13. However, provision for diminution should be made to recognize a decline other than temporary in the value of the long term investments.*

20. The broad issues raised in the above paragraphs are still to be resolved by the Research Committee and the Council of the ICAI. In view of this, the views expressed herein regarding preference for accounting treatments as per FRS 5 may undergo change.

Originator's financial statements

Indications that derecognition is appropriate (securitised assets are not assets of the Originator)	Indications that a linked presentation is appropriate	Indications that a separate presentation is appropriate (securitised assets are assets of the Originator)
Transaction price is arm's length price for an outright sale.	Transaction price is not arm's length price for an outright sale.	Transaction price is not arm's length price for an outright sale.
Transfer is for a single, non-returnable fixed sum.	Some non-returnable proceeds received, but Originator has rights to further sums from the issuer, the amount of which depends on the performance of the securitised assets.	Proceeds received are returnable, or there is a provision whereby the Originator may keep the securitised assets on repayment of the loan notes or re-acquire them.
There is no recourse to the Originator for losses.	There is either no recourse for losses, or such recourse has a fixed monetary ceiling.	There is or may be full recourse to the Originator for losses, e.g.: - Originator's directors are unable or unwilling to state that it is not obliged to fund any losses; - noteholders have not agreed in writing that they will seek repayment only from funds generated by the securitised assets.

Annexure – III

(see para 8.1.5, 10.2.5 &, 10.3.2)

Disclosure of Information to Investors

Introduction :

Securitisation is a new and emerging concept in India. However, it has the potential to become one of the largest sources of debt finance in the country. One of the key elements in the development of this market would be investor acceptability. While in the initial stages, the market is expected to be limited to institutional investors, eventually it has to attract the participation of retail investors. Considering the novelty of the concept, it is imperative that investors are able to identify and comprehend the various risks associated with investing in securitised debt and make an informed investment decision. Investor acceptability would be driven by the extent to which such risks are disclosed and explained. In this context, the need for adequate disclosures and information dissemination mechanism cannot be overemphasised.

The present paper seeks to outline some of the key information requirements that are required to be disclosed in the Offer Document as a best practice model. While recognising that the nature of information would vary depending on the types of asset classes that would be securitised, an attempt has been made to introduce an element of uniformity in the disclosure requirements across asset classes.

Information requirements

(i) **Terms of the Offer**

The offer document should seek to provide information describing the terms of the offer. Typically the summary terms of the offer should include :

a) Description of the instruments (pass through, pay through, Class A, Class B etc.)
b) Maturity/Redemption
c) Interest rate, probable yields
d) Interest and principal payment dates
e) Optional redemptions, if any
f) Description of underlying Security
g) Terms of payment
h) Minimum Application
i) Interest rate on application money
j) Offer programme - Opening and Closing dates
k) Listing details / Transferability
l) Rating of the securities and explanation of the rating. The text of the rating rationale could be provided as an Annexure.

The rating rationale should seek to comment on the following :

- Quality of the receivables and strength of the cash flows
- Payment structure
- Adequacy of the credit enhancements
- Originator profile
- Risks and concerns for investors and the mitigating factors
- Any other relevant information

(ii) Description of the Issuer (SPV)

This should include constitution, activities, ownership, capital structure and other details of the Issuer

(iii) Objects of the Offer and end use of funds

(iv) Transaction Structure

The structural summary should provide brief information regarding the key structural features of the transaction. This would include :

a) Transfer of receivables and flow of funds (ideally represented by a schematic diagram)

b) Priority of distributions and allocation of funds

- Servicing Fee, Trustee Fee etc.
- Class A Securities Interest
- First allocation of principal
- Class B interest
- 2nd allocation of principal
- Reinstatement of reserve account, if any

c) Early Amortisation events, trigger clauses etc.

d) Events of default and change in priority of distributions on occurrence of such events

(v) Statement of Risk Factors

The investors should be informed about the risk factors typical of investing in instruments of securitisation. (This would be in addition to normal disclosures on market risks associated with investments in securities). Normally, these would be :

a) Prepayment risks – Prepayment on receivables will cause prepayments on the securities resulting in reinvestment risk to the investor

b) Potential loss on securities due to limited assets of the SPV

c) Bankruptcy of Originator could result in losses or delays in payments on the securities (i.e. in the event the court in the bankruptcy proceedings concludes that the sale is not a "true sale")

d) Prepayments, potential losses and change in order of priority of principal payments following an event of default.

e) Risks arising out of geographic concentration of receivables, if any

f) Any other risk specific to the transaction and asset class.

(vi) <u>**Disclaimers**</u>

That ,

- The ABS / MBS do not represent deposits, liabilities of the Originator, servicer, SPV or the Trustee and that they are not insured

- The Trustee / originator / servicer / SPV does not guarantee the capital value of the ABS or the collectibility of the receivables pool

- The Regulators are not liable for any losses to the investors

(vii) <u>**Information related to other risks**</u>

The extent of information requirement would depend on the nature of risk associated with a particular transaction. Broadly stated, these risks are asset risk, third party risk, legal risk, and cash flow risk. Of course, in addition to these risks, investors bear the market risk that the value of their investment will change. The disclosures in the offer document should not only aim to inform the investors about these risks but also provide sufficient information on the various parameters governing these risks so that they are able to assess and measure these risks.

Given this objective, the broad disclosure requirements against each of the risk categories could be as under:

A. <u>Asset risk</u>

The assets backing a securitisation are its fundamental credit strength. Therefore, the risk associated with the performance of the asset(s) and the obligors behind them needs to be analysed and disclosed in detail.

The standard disclosures on asset performance could be:

I. Description of the assets: For example, if the asset is a pool of loans (e.g. car loans), **pool information** would comprise the following :

a) Summary of the pool of loans:

Number of loans in the pool :

Original loan amount disbursed :

Loan outstanding as on ------

Maximum loan amount :

Minimum loan amount :

Average loan amount

Original maturity of the loans :

Residual maturity of the loans :

Minimum original Loan to value ratio:

Maximum original Loan to value ratio:

Weighted average original loan to value ratio :

Weighted Interest rate of the pool :

b) Distribution of pool by original Loan to Value ratio *

*** Explanation of LTV ratio and its implications to be provided for the benefit of understanding by retail investors**

LTV	No.of loans	Proportion of total pool by number	Outstanding Principal Amount	Proportion of total pool By amount	Weighted Average Original LTV
<=60 %					
60-70%					
-----					

c) Distribution of pool by outstanding principal amount

Princ. O/S	No.of loans	Proportion of total pool by number	Outstanding Principal Amount	Proportion of total pool by amount	Weighted Average Original LTV
< 5 cr.					
5-10 cr.					
-----					

d) Distribution of pool by residual maturity

Residual maturity (months)	No.of loans	Proportion of total pool by number	Outstanding Principal Amount	Proportion of total pool by amount	Weighted Average Original LTV
25					
26					
-----					

e) Geographical distribution of pool

Location	No.of loans	Proportion of total pool by number	Outstanding Principal Amount	Proportion of total pool by amount	Weighted Average Original LTV
Delhi					
Mumbai					
-----					

f) Distribution by interest rates

Interest (%)	No. of loans	Proportion of total pool by number	Outstanding Principal Amount	Proportion of total pool by amount	Weighted Average Original LTV
< 15					
15-16					
-----					

g) **Distribution by loan types**

For certain specific type of loans like student loans etc. some additional disclosures on the following lines may be required :

Loan Type (%)	**No. of loans**	**Proportion of total pool by number**	**Outstanding Principal Amount**	**Proportion of total pool By amount**
Subsidised				
Unsubsidised				
Guaranteed				

II. Declaration on historical performance (delinquencies / defaults / overdues / guarantee claims if any, etc.)

The Originators experience with respect to its portfolio of loans / sales contracts. While it is not necessary that the behaviour of the pool will be comparable to the Originator's experience, it may be necessary to provide some indications to an investor on the past performance. For example, for a pool of consumer loans (say) :

a) **Delinquency experience**

	1997	1998	1999
E.g. Average number of contracts outstanding			
Average monthly number of contracts delinquent			
Average monthly delinquencies as a % of average contracts outstanding			

b) **Credit Loss and Repossession Experience**

	1997	1998	1999
Average portfolio outstanding			
Repossessions as a % of Average			
- Number of contracts outstanding			
Net losses as a % of average portfolio outstanding			

* "Net losses" are equal to the aggregate balance of all contracts which are determined to be uncollectible in the period less any recoveries on contracts charged off in the period or prior periods

III. If the asset is in the nature of a debt from a **single obligor** (e.g. lease rental from a corporate / loan from a single corporate), then detailed information about the obligor performance needs to be suitably disclosed. Such information could comprise the following :

a) Description of the obligor's activities
b) Past 3 years of financial performance
c) Existing ratings of outstanding securities
d) Declaration on outstanding disputes/ litigation
e) Past defaults etc.

If the asset is in the nature of a pool of debt from **multiple obligors**, such information could be provided for those obligors whose debt constitute more than 25 % of total debt in the pool.

IV. Information about Originator : To arrive at a judgement on the likely performance of an asset in future, investors would also need to have adequate information about the Originator and the credit origination procedure. This is particularly relevant for future flow receivables where the performance risk remains linked to the Originator. Information about the Originator could comprise the following :

a) Business profile of the Originator
b) Industry structure and the competitive scenario
c) Capital Structure
d) Management
e) Credit extension norms and process. This would include a statement on the loan sanctioning criteria, appraisal norms, approval mechanisms, credit supervision & collection mechanism etc.
f) Asset quality and capital adequacy
g) Loan default / Credit loss – historical experience

h) Claims against the Originator, disputes, contingent liabilities etc.

B. Third party risk

In the absence of its own executive staff, an SPV must rely on third parties to provide all its services and execute all its functions. Other third parties provide credit enhancement and ancillary facilities to SPVs as appropriate to the specific asset backed transaction. At the interface between the SPV and the investors, additional third parties carry out trust and agency responsibilities. The investors are at risk on the solvency and performance of each third party which bears responsibility for passing funds through to the SPV or onwards to investors. Information requirements on third party risk could be as under :

I. Credit Enhancer Risk :

a) **External forms of credit enhancement :** For example, if the performance of an asset is guaranteed by a third party then adequate information about the credit strength of the guarantor needs to be provided. Such information could be in the following format :

(i) Brief description of the Company's activities

(ii) Past 3 years financial performance

(iii) Details of outstanding guarantees and other contingent liabilities

(iv) Existing ratings of the Company's outstanding debt securities

b) **For internal forms of credit enhancements :**

(i) Information about the extent of overcollateralisation

(ii) Information about the cash collateral reserve account (e.g. mode of the collateral – cash deposit, L/C, bank guarantee etc., replenishment / reestablishment mechanism)

II. Administration / Servicing risk

Given that the cash generated by the asset is the fundamental strength of a securitisation's credit quality, it follows that proper administration of the underlying receivables is a fundamental third party risk. The prime task is the timely collection of receivables. In this role the administrator conducts all correspondence and contacts with the obligors over their performance including enforcement of any related security. If physical security underlies the receivables portfolio, the administrator is responsible for the safe custody of the supporting

security. As a natural corollary of its collections responsibilities, the administrator is also charged with operating the SPV's bank accounts, with keeping accounting and management information records on behalf of the SPV and with reporting on the performance of the portfolio at regular intervals. Internationally, while specialist third party administrators do exist, the seller of the assets usually continues to administer them under contract to the SPV. In view of the above, the following information about the administrator/servicer needs to be disclosed :

a) Duties of the servicer – This would imply disclosing salient features of the Receiving and Paying Agency (RPA) / Servicing and Paying Agency agreement. The agreement could form a part of material disclosure.
b) Servicing compensation
c) Procedure for replacement of Servicing and Paying Agent
d) Information furnishing obligations of the Administrator / Servicer to the Rating agencies / Trustees

III. Disclosure on Trustees

(i) Brief profile of the Trustees
(ii) Duties and responsibilities
(iii) Remuneration
(iv) Procedure for replacement

C. <u>Legal Risk</u>

The Offer document should seek to apprise the investor about the legal aspects of the transaction. The investors should be aware of their interest and rights on the receivables and the underlying collateral. Information about repossessions / foreclosures etc. should be furnished. If any legal opinion is obtained (e.g. opinion on true sale etc.), the same should be appropriately reproduced with the consent of the opinion provider.

Suitable disclosures regarding the Deed of Assignment, agreement to assign etc, should be made. The Deed of Assignment should be made part of the Material Document.

Taxability

Disclosures on the taxability of the SPV, and the holders of the securities, supported by appropriate legal opinion / clarifications should be made.

D. Cashflow Risk

The manner in which the cash generated by the assets and third party facilities backing a securitisation is channeled to debt holders is the focus of cash flow risk. Cash intended to service or repay debt holders may come from a number of sources – principally collections on underlying receivables, draws on credit enhancement facilities etc. There is an associated credit risk on the administrator who, as Originator, may be in direct receipt of collected funds or draws under credit enhancement facilities. To apprise the investor of these risks, the offer document should seek to disclose details of:

a) Operation of different collection accounts
b) Cashflow appropriation and distribution. Details of any structured payment mechanism (escrows etc.) should be provided.
c) Detailed cash flow schedule for the life of the instrument(s), assumptions underlying the cash flow projections
d) Treatment of prepayments and historical prepayment pattern

   Prepayment risk exists in most pass through structures and affects the average life of the securities. Prepayments expose the investors to reinvestment risk and therefore, some indications of historical prepayment patterns may have to be disclosed.

Continuing Disclosures

In addition to the initial disclosures in the offer document the investors would need to be apprised of the performance of the asset on a continuous basis at periodic intervals throughout the life of the security. Such information should comprise the following:

(i) Collection summary for the previous collection period
(ii) Asset pool behaviour – delinquencies, losses, repurchases, prepayments etc during the period
(iii) Drawals from credit enhancements, if any
(iv) Distribution summary
   - in respect of principal and interest to each class of security holders
   - in respect of servicing and administration fee, trusteeship fee etc.
   - payments in arrears

(v) Any other information relevant to the performance of a particular asset class

Normally, information on the asset performance is periodically reported to the rating agency(s) who have a system of surveillance through which the performance of the asset portfolio is monitored on a continuous basis. It is suggested that such information is also made available to the Trustees and the Stock Exchanges where the instruments are listed, at quarterly intervals throughout the life of the instrument. Further, the rating agencies could be requested to publicise the rating of the instruments at quarterly/semiannual intervals.

Conclusion :

As mentioned earlier, the extent and nature of information disclosure requirements would vary depending on the typicality of the asset class that is being securitised. For example, the disclosure requirements for an existing asset which is in the nature of loans would be different from that of future flow securitisation transactions like securitisation of future ticket receivables, future remittance securitisation etc.

This issue 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 above. For public issues such disclosure requirements should be made mandatory by the regulator. It is also suggested 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 - IV

(para 8.1.8, 10.2.2.2, & 10.2.6)

Proposed Prudential Guidelines

Objectives of securitisation:

The banks, FIs or NBFCs may seek to achieve one or more of the following objectives by securitisation:

1. To create room in the balance sheet to meet the capital adequacy norms prescribed by the regulatory authority.
2. To increase return on equity by redeployment of the capital in higher yielding assets.
3. For the purpose of risk management.
4. To correct large exposures to borrowers, asset classes or geographical concentrations.
5. To reduce the cost of funds and achieve diversification of sources of funding.

Rationale for regulation:

In a securitisation transaction the functions carried out by the Originator and the corresponding risks associated with such functions are unbundled and distributed across different participants. The capital maintained against the assets by the bank prior to the securitisation provides cushion against all the risks associated with the asset of which credit risk is the most prominent. In the post securitisation scenario the originating bank manages to pass the credit risk to third parties but may still be left with risks associated with loan servicing or moral recourse risk. Moral risk may assume significant proportions in the case of a single loan securitisation where close association of the Originator with the loan can not be camouflaged whereas in a pool of loans the level of association may not be so prominent. On the other hand the array of roles a bank may have to carry out is large in securitisation of a pool of loans than in a single loan. From the regulators point of view a bank carrying out one role will have more regulatory freedom than one carrying out several roles for obvious reasons. Further, close identification of a bank with a loan makes it more amenable to moral risk. As a result it may be under pressure to support losses incurred by the investors/buyers to protect its reputation. Likewise, a sponsor may be more open to moral risk than a mere

repackager in securitisation scheme of certain types where the Originator is merely a conduit and assets never had been on its balance sheet.

Therefore, depending on the roles carried out by a bank in a securitisation scheme the regulatory guidelines will aim to determine the measure the bank should take to hedge risks associated with such roles. The regulatory prescriptions are normally in the form of capital charge. In certain cases, however, the regulatory authority may impose limits on the size and types of assets to be securitised.

The guidelines are *mutatis mutandis* applicable to the sponsors and repackagers of loans. If, however, the assets at any time appeared on the balance sheet of the repackager the same are not considered a repackaging scheme. Moreover the repackaging should be undertaken in freely tradable bond and securities.

Reporting:

The Regulatory Authorities in all the emerging markets as well as some of the developed countries retain control over the securitisation by the banks and the financial institutions under their jurisdiction. The control is in the form of either prior consultation as is the case in England under the FSA guidelines, Hong Kong under Hong Kong Monetary Authority (HKMA) guidelines or prior approval by the respective authorities in Singapore, Malaysia, Philippines, Korea and Thailand etc. The Regulatory Authorities want to assess the impact of the securitisation deals on the risk profiles of the banks and FIs. In a recent study by BCBS on Capital Requirements and Bank Behaviour, it has been brought out that the banks in US are using securitisation to alter the profile of their book. The situation elsewhere would be no different. This may make a bank's capital look artificially high relative to riskiness of the remaining exposures, and in some cases may be motivated by a desire to achieve exactly this. The very broad categories in the Basle Accord give scope for the banks to arbitrage between their economic assessment of risk and the regulatory capital requirement. Securitasition is an important technique for undertaking such capital arbitrage but may not be sole motivation. Capital arbitrage exploits the large divergence that can arise between a portfolio's true economic risk and the regulatory measure of risk. There are four major types of capital arbitrage:

- Cherry picking.
- Securitisation with partial recourse

- Remote origination
- Indirect credit enhancement.

The measurement of credit risk is a difficult task and can never be done in absolutely precise terms. Therefore, the regulatory authority needs to be reassured that the banks and FIs are sufficiently equipped to handle the risks to which they may be exposed and the scope for capital arbitrage can be minimized. Hence it is felt that banks and FIs (including NBFCs) intending to originate securitisation deals should inform their plans to the regulatory authority at least one month in advance.

The secritisation program should have the approval of the Board of Directors of the originating institution.

Focus of the guidelines:

The regulatory guidelines will broadly address the following concerns:

1) All parties involved in the securitisation understand responsibilities and risks they assume and provide for the same.
2) The intended reapportionment of rights and obligation as a result of securitisation is achieved among sellers, buyers and other service providers and the same is well documented and legally enforceable.
3) The risks arising from securitisation are hedged through appropriate measure like capital charge or other stipulations.
4) Complete legal, economic and moral separation of seller from assets and new owners.
5) The remaining assets portfolio of the institution should not deteriorate to such an extent that it becomes a mater of concern for the regulatory authority .

It may be added that securitisation is an area , which is continuing to develop, and the Indian Regulators will continue to review their policy in the light of market developments.

In order to achieve the above concerns the following guidelines are being proposed which are in consonance with international best practices:

Criteria for True Sale:

It is important that the Originators are not required to contribute for any expenses / losses to investors beyond the documented credit enhancement and other expenses.

In order that the Originators are able to remove the assets from the balance sheet and get the regulatory capital relief, the following conditions should be met:

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. A seller may however, provide credit enhancement to the securitisation structure on the terms set out in the guidelines. A seller may also be entitled to any surplus income generated over the life of securitisation transactions by means of a separate written agreement with SPV.

v. An opinion from the solicitors/external auditors of the seller should be kept on record signifying that all rights in the assets have been transferred to SPV and Originator is not liable to investors in any way with regard to these assets. Regulatory authority expects the servicing agent and Originator to have evidence available in their records that their auditors and legal advisors are satisfied that the terms of the scheme protect them from any liability to the investors in the scheme, other than liability for breach of express contractual performance obligations.

vi. The buyer should have no formal recourse to the seller for any loss except through the mechanism of credit enhancement or liquidity facility for which a written agreement should be entered into at the time of origination of securitisation.

vii. The seller may not give any representation or warranty in respect of the capital and/or future performance of the ABS issued by SPV as well as future credit worthiness of the underlying assets.

viii. The transfer of assets from seller must not contravene the terms and conditions of any underlying agreement governing the assets and all necessary consents should have been obtained to make transfer fully effective.

ix. The seller should not be under any obligation to repurchase any asset sold except where the obligation arises from a breach of any representation or warranty given in respect of the nature of the assets at the time of transfer. A notice to this effect should be given to the SPV and investors and they should have acknowledged the absence of such obligation. An option to repurchase fully performing assets at the end of the securitisation scheme where such assets have in aggregate fallen to less than 10% of the original amount sold to the SPV (clean up calls) may, however, be retained by the seller.

x. Seller should not be involved as a market maker in the securities backed by asset sold by him by giving two way quotes.

xi. Seller may purchase senior securities issued by the SPV at market price for investment. Such purchase should not exceed 5% of the original amount of the issue.

xii. Except for underwriting commitment seller must not commit it to purchase securities prior to initial issue.

xiii. The seller may underwrite the issue of securities by the SPV on an arms length basis. The devolution of any subordinated notes on the seller, as a result of underwriting, will be deemed as a credit enhancement for the purpose of capital adequacy treatment. Any devolved senior or subordinated securities should be brought to the notice of the Regulatory Authority and disposed off in a time bound manner.

xiv. The seller and SPV may enter into currency/interest rate swap arrangements for hedging purposes. Such transactions must be entered into at market rates.

xv. In case of any re-schedulement or re-negotiation of any loan included in the assets the SPV and not the seller would be subject to altered terms if any.

xvi. If the payments are routed through the seller he should be under no obligation to remit funds to SPV unless and until these are received from the borrower.

xvii. The Originator should not hold substantial interest in the SPV either directly or indirectly. They may however have one member on the board of directors. Further, the name of SPV should not have any resemblance with the name of the Originator.

If the above conditions were not fulfilled then the transfer of assets would not be regarded as a true sale but only a financing transaction. The seller in that case should reflect the underlying assets on its balance sheet for capital adequacy purposes. RBI may regard assets removed from a bank / Financial Institution/ NBFC's balance sheet through securitisation, even where the scheme meets RBI's requirements, as carrying some residual risk to the Originator (e.g., pool of assets not properly segregated from Originator's other assets, co-mingling of cash flows etc.).
(Terms seller and buyer have been used interchangeably for Originator and SPV)

Guidelines for Providers of Credit Enhancement Facilities :

Credit enhancement facilities include all arrangements viz. subordinated loan, over-collateralistion, spread accounts, investment in subordinated tranches of securities etc. that, in form or substance, provide for a seller or a third party agent to absorb the losses of a SPV or investors. These facilities play an important role to enhance the credit rating of the securitisation instruments. Credit enhancement arrangement should ensure that the following conditions are fulfilled:

i. The nature of the credit enhancement provided to a transaction is clearly specified in a written agreement at the time of origination transaction and disclosed in the offering document. There should not be any recourse to the enhancer beyond the fixed contractual obligations so specified. In particular the enhancer should not bear any recurring expenses of the securitisation.

ii. The facility should be provided on an arms length basis and is subject to enhancer's normal credit approval and review process. The facility should be provided on market terms and conditions.

iii. The facility is limited to a specified amount and duration.

iv. In case where the enhancer is the seller, the credit enhancement facility must be documented in a way that clearly separates it from any other facility provided by the seller.

v. Where any of the above condition is not satisfied the enhancer is required to hold capital against the full value of all the securities issued by the SPV.

vi. The enhancer will be required for capital adequacy purpose, to deduct the full amount of credit enhancement facility from its capital base. The deduction will normally be capped at the amount of capital, which the seller would be required to hold for the full value of the assets if they had not been otherwise securitised. The authority may, however, impose a higher regulatory capital charge, if it considers necessary to do so in the prudential interest of the enhancer.

vii. In the case where seller transfers assets to a SPV for a value below their book value (e.g. under an over collateralisation agreement or by sale at a discounted price), the difference should be treated as a credit enhancement, unless the seller writes off the difference in value upfront against its P & L A/c.

viii. Credit enhancement should be undertaken only at the initiation of the scheme except in the event of a scheme having subsequent tranches of assets being placed in to the SPV.

ix. It should be examined whether banks would be allowed to provide guarantees to investors for the limited purpose and credit enhancement.

x. The credit enhancement in the form of guarantees will be treated as commitment and converted at 100% conversion factor.

Guidelines for Providers of Liquidity Facility :

(i) Liquidity facility enables an SPV to assure investors of timely payments. This includes smoothing timing differences in the receipt of interest and principal on pooled assets and servicing the securities. In view of the variety of cash flows to be provided to the investors, it may be unavoidable for the SPV to resort to temporary liquidity facilities from different suppliers of such credit. The provider of liquidity facilities to a SPV should ensure that the following conditions are met.

(a) The provider must not bear any of the recurring expenses of securitisation.

(b) The facility should not be capable of being drawn for the purpose of credit enhancement.

(c) The nature of credit facility provided to a SPV should be clearly specified in a written agreement at the time of origination of the securitisation transaction and disclosed in any offering document. There must be no recourse to the provider beyond the fixed contractual obligation.

(d) The facility should be provided on an arms length basis and be subject to providers' normal credit approval and review processes. The facility must be on market terms and conditions.

(e) The facility should be limited to a specified amount and duration.

(f) The facility should be reduced or terminated should a specified event relating to deterioration in the asset quality occur.

(g) Payment of fees or other income for the facility should not be subordinated, subject to deferral or waiver.

(h) Funding should be provided to SPV and not directly to the investors

(i) Funding under liquidity facility shouldn't be used to cover losses of the SPV.

(j) Drawings under the facility should be repaid within a reasonable period and should not be subordinated to the interest of the investors.

(ii) Liquidity facility will be treated as commitment to provide finance for capital adequacy purposes.

(iii) In case the liquidity facility fails to meet requirement (a to k) above, it will be treated as credit enhancement for the purpose of capital adequacy treatment.

(iv) The Originators may not provide liquidity facility to their securitisation schemes without the prior permission of Regulating Authority.

Guidelines for Service Providers:

A service provider will normally assume obligations such as collection from obligors, payment to the investors, reporting on the performance of the pool etc. in an asset securitisation scheme. These functions may continue to be performed by the professional organisations having the desired skills. A bank or a FI may act as a servicer for the SPV provided that:

i. There is formal written agreement in place that specifies the services to be provided and standards of performance required from the servicer. There should not be any recourse to the servicer beyond the fixed contractual obligations specified in the agreement;

ii. The services are provided on an arm's length basis, on market terms and conditions;

iii. The SPV and/or investors have the clear right to select an alternative party to provide the facility;

iv. The facility is documented separately from any other facility provided by the bank or FI;

v. Its operational systems (including internal control, information system and employee integrity) are adequate to meet its obligations as a servicer.

A bank or FI acting as a servicer should be under no obligation to remit funds to the SPV or investors until it has received funds generated from the underlying assets. Where the conditions as above are not met the service providers may be deemed as providing liquidity facility to the SPV or investors.

Additional guidelines for special structures:

Revolving structures:

1) The structuring of the securitisation of revolving credits should ensure full sharing of interest, principal, expenses, losses and recoveries on clear and consistent basis. There should be full loss sharing on the receivables in the pool throughout the revolving period of securitisation.
2) The scheme should not contain any feature whereby the performance of the pool systematically favours the investor's interest.
3) Adequate seasoning of the accounts transferred in the pool should be done as also the random selection of assets into the pool to ensure that investors do not derive any systematic advantage.
4) The servicing practices should be applied consistently to securitised and unsecuritised assets.

5) The scheduled amortization should not be so structured that the investors might avoid their full share of losses at the end of the revolving period.
6) The scheduled amortization should be so structured that the borrowers in the pool should have made sufficient payments to ensure that 90% of debt outstanding at the beginning of the amortization period or recognized in default.
7) The early amortization triggers should not be such that in effect these provide implicit credit support to the investors. There should be full sharing of interest, principal, expenses, losses and recoveries on the balances at the start of the amortization period. The bank also should be able to reduce its lending, without loss of reputation, in consonance with amortization of investors' interest if losses reach beyond tolerance level.
8) The liquidity implications of revolving structures should be handled within the banks' asset liability management system. Each scheme should be included in a banks' ALM system assuming that the bank may be required to find replacement or additional funding for the full amounts previously provided by the investors interest. In addition, a bank should include warning indicators for early amortization triggers and committed facilities capable of being drawn in case of need.

Securitisation of financing of equipment and consumer goods:

1) There are certain liabilities involved in such financing which are difficult to transfer to buyers of receivables in a securitisation transaction e.g. servicing of equipment by lessor or under hire purchase agreement or liability for personal injury etc. It is important, therefore, that the seller should either receive indemnity from the buyer or minimize the risk through appropriate insurance cover.
2) If the bank is buyer of such assets it should satisfy itself of seller's competence to fulfil its obligations towards borrower in a timely manner failing which borrowers may renege on their commitment to pay.

Investment in ABS/MBS:

i. The investment by the banks and FIs in securitised instruments irrespective of the form should be treated at par with the debt instruments and no limit should be placed on such investment.

ii. If the investment in securitised instruments exceeds 10% of the total investments of an institution the same should be disclosed to the regulatory authority.

iii. With a view to encourage investors to assume credit risk in those sectors of the economy where they would not invest normally, but those sectors are important for the overall economic development of the country, the government / central bank has been encouraging investments in these sectors by financial institutions. It is therefore felt that investment in securitised instruments backed by receivables from the following sectors should be given Priority Sector Lending status:

- Infrastructure
- Housing
- SSI, SRTO

iv. Overseas investors should be allowed to invest in the securitised instruments. A policy regarding this should be framed and made public.

v. The net result of securitisation is greater credit transparency, isolated risk ownership, and segmented risk absorption, which results in a funding cost that is lower than traditional lending. As a result, securitised instruments require lower level of capital support to provide similar levels of protection to holders of such instruments. The risk weight for investments in securitised instruments need to be defined. Bank for International Settlement has recently published a suggestive paper stipulating risk weights based on the credit ratings. These were deliberated in detail and it was felt necessary to suggest suitable risk weights to encourage investment in such instruments based on credit ratings as ratings will play an important role in attracting investors. The Group felt that there should be minimum risk weight for the best-rated paper, which has superior identifiable cash flows (AAA to AA-). With adequate disclosure norms and mandatory ratings, the quality of the underlying assets in the securitisation transaction is more transparent for an informed decision by an investor. For low quality papers (BBB+ to BBB-), the investors may have to maintain 100% capital adequacy. It may be added that the risk weights of the securitised papers are based on the proposals contained in the BIS paper on the subject, which is still under consultation process till March 2000. The actual risk weights may be decided by RBI after Basle Committee recommendations are implemented.

vi. For the purpose of capital adequacy on the investments in securitised paper the following risk weights should be applied:

Rating of the security(S&P methodology or Equivalent)	Risk Weight to be applied %
AAA to AA-	20
A+ to A-	50
BBB+ to BBB-	100
BB+ or below/unrated/Subordinate tranches	To be deducted from the capital subject to a cap of capital requirement on total assets securitised

The investment in residential mortgaged-backed securities, which are either self or tenant occupied may be given 50% risk weight of the corresponding ABS .

vi. Banks and Financial Institutions investing in the ABS/MBS will get exposed to the pool of assets/mortgages/obligors underlying such securities. The institutions therefore, should guard against concentrations of exposures to a particular industry/sector, institution or geographic area. In the case of a large number of underlying obligors, the exposure may be treated against this particular sector to which the pool of assets belong. In case there are one or two obligors, the exposure may be treated against those obligors. In case there are a few identifiable obligors, each of whom has the share of 25 per cent or more in the pool of assets, the exposure may be treated proportional against those borrowers. The FIs should take into accounts exposures through investments in securitised paper or combination of such paper with other credit exposures for the purpose of complying with prudential guidelines on exposure to an individual borrower or a group.

vii) Income recognition and asset classification norms would apply to investment in securitised paper as per extant guidelines of RBI.

APPENDIX

Proposed Proforma of Reporting to Regulatory Authority for origination of Securitisation Scheme by Banks/FIs and NBFCs

Name of the originating bank/FI/NBFC

Full names , addresses of directors and names of the companies where they are directors

Name and nature of SPV & details of relationship with Originator (including constitution and shareholding pattern)

Structure of SPV and its relationship with the trustee/administrator/servicer, if any

Description and nature of asset transferred

Carrying cost of assets transferred and % to total assets before transfer

Method of transfer - Enclose a copy of the agreement/deed b/w Originator and SPV (indicate, interalia, NOC from other creditors, consent of the obligors' etc.)

Transfer consideration
(Monetary and other)

Objects and economics of the securitisation offer

Projected cash flow for the remaining tenor of the assets being securitised :

Proposed utilisation of amount realised by the Originator (indicate how the rights of other creditors are protected especially for securitisation of assets in which other creditors have interest)

The accounting treatment of the assets before and after securitisation

Any existing charge on assets securitised and how it is proposed to be satisfied

Classification (as per RBI norms) of assets transferred

Amount and nature of credit enhancement provided (give details of all facilities provided viz. amount, duration, terms and conditions, enclose copy/ies of agreement)

Any other facility viz. liquidity servicing/administration of assets, underwriting provided (copy of agreement to be enclosed)

CRAR of transferor :

	Before transfer	*After transfer*
Tier I		
Tier II		

Type and classes of securities issued by SPV
with ratings of each by approved rating agency

Whether public issue or private placement

Name and address etc. of holders of
5% or more of securities (if available)

Names and addresses of other credit enhancers, liquidity
facility providers, servicer/administrator along with
description of facility, terms and condition of each facility

Investment by Originator in the securitised paper issuer wise

Class of security	No. of securities held	Total amount

Total expenses incurred on the securitisation scheme

Certificate of solicitor/chartered accountant
signifying true sale as per RBI guidelines

Due diligence report of the merchant banker/
arranger/manager to the issue

Details of hedging arrangements
IRS/currency swaps giving amount/due
date name of counter parties etc.

Brief description (including diagrammatic representation of
the structure) of the scheme denoting cash and process flows

Date and method of termination of the scheme
including mopping up of remaining assets

Other documents to be enclosed:
Offer document, Prospectus, Servicing Agreement, Trustee
Agreement, financial valuation model provided to investors,
if any etc.(copies of drafts of all contracts between various
entities taking part in the transaction)