LAW MANTRA THINK BEYOND OTHERS
(I.S.S.N 2321- 6417 (Online)
Ph: +918255090897 Website: journal.lawmantra.co.in
E-mail: info@lawmantra.co.in contact@lawmantra.co.in

REGULATORY FRAMEWORK OF SECURITIZATION IN INDIA *

Introduction

Securitisation is the process of converting illiquid assets like bad debt into liquid assets like securities through a legal tool of financial engineering. As a financial tool, it structures the flow of finances fruitful for the stakeholders. In the first stage bad debts backed by securing assets are purchased by Special Purpose Vehicle (Herein after referred as SPV) and in the second stage SPV converts the bad debt into negotiable securities. Securitization is the creation and issuance of debt securities, or bonds, whose payments of principal and interest derive from cash flows generated by separate pools of assets. Bank and financial institutions have understood its benefit and used it as a tool of financing for its Mortgage-backed securities (Hereinafter referred as MBS) and asset-backed securities (Hereinafter referred as ABS).

To initiate a securitization, a company must first create what is called a special purpose vehicle (SPV) in the parlance of securitization. The SPV is legally separate from the company, or the holder of the assets. Typically a company sells its assets to the SPV. The payment streams generated by the assets can then be repackaged to back an issue of bonds. Or, the SPV can transfer the assets to a trust, which becomes the nominal issuer. In both cases, the bonds are exchanged with an underwriter for cash. The underwriter then sells the securities to investors. Unlike other bonds, securities backed by mortgages usually pay both interest and a portion of the investor's principal on a monthly basis.[1]

This idea was firstly practiced in the U.S. in 1970 with the securitization of U.S. government-guaranteed residential home mortgages by the Government National Mortgage Association. Over the course of the 1980s, a market emerged for consumer asset-backed securities (ABS) in the United States and residential mortgage-backed securities (RMBS) in the United Kingdom. The 1990s saw the issuance of securitized commercial real estate assets in the United States, in addition to the development of the ABS and mortgage-backed securities (MBS) markets in both continental Europe and the United Kingdom. By the turn of the century, the issuance of U.S. private-label securitizations stood at US$1 trillion, around five times that of Europe (IMF, 2009). Dramatic changes in the composition of the industry, then unfolded in the years immediately preceding 2007, some of which had a significant impact on the global financial system.[2]

In India, to fight the menace of rising Non Performing Assets (Hereinafter referred as NPA), the government has constituted Narshimahan Committee, which has recommended for creation of Assets Recover funds to deal with the problem of NPA and bad debts. Accordingly, Securitisation

* Dr. Rajesh Kumar, Assistant Professor (Selection Grade), NUSRL, Ranchi.

[1] Statement of Cameron L. Cowan Partner Orrick, Herrington, and Sutcliffe, LLP On behalf of the American Securitization Forum, Available on https://financialservices.house.gov/media/pdf/110503cc.pdf.

[2] Securitization: Lessons Learned and the Road Ahead Miguel Segoviano, Bradley Jones, Peter Lindner, and Johannes Blankenheim, Avaialble on https://www.imf.org/external/pubs/ft/wp/2013/wp13255.pdf.

and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, (`SARFAESI Act`) were enacted to enforce the mechanism of securitisation.

The Supreme Court in the case of *the M/S Transcore v Union of India* held that "Non-Performing Assets (NPA) is a cost to the economy. When the Act was enacted in 2002, the NPA stood at Rs. 1.10 Lac crores. This was a drag on the economy. Basically, NPA is an account which becomes non- viable and non-performing in terms of the guidelines given by the RBI. As stated in the Statement of Objects and Reasons, NPA arises on account of mismatch between asset and liability. The NPA account is an asset in the hands of the bank or Financial Institutions (Hereinafter referred as FI). It represents an amount receivable and realizable by the banks or FIs. In that sense, it is an asset in the hands of the secured creditor." [3]

It was further held that "this act was primarily enacted to reduce the non-performing assets by adopting measures not only for recovery but also for reconstruction. Therefore, the Act provides for setting up of asset reconstruction companies, special purpose vehicles, and asset management companies etc. Which are empowered to take possession of secured assets of the borrower, including the right to transfer by way of lease, assignment or sale. It also provides for the realization of the secured assets. It also provides for the takeover of the management of the borrower company."[4]

So, while upholding the constitutional validity of SARFESI Act, 2002, the Supreme Court has considered linkage between importance of strong recovery laws for success of securitisation as a tool for financing and development of economy.

Concept of Securitization in India

Securitisation involves acquisition of assets of bank and Financial Institutions (Hereinafter referred as FI) by Special Purpose vehicle which is a Securitisation Company (hereinafter referred as SC) and the Reconstruction company (Hereinafter referred as RC) in India. Securitisation is defined as "securitisation means the acquisition of financial assets by any securitisation company or reconstruction company from any originator, whether by raising of funds by such securitisation company or reconstruction company from qualified institutional buyers by the issue of security receipts representing an undivided interest in such financial assets or otherwise; [5] Prof. Vinod Kothari, an expert in securitization, explains securitization as ""Securitisation" in its widest sense implies every such process which converts a financial relation into a transaction. The history of evolution of finance, and corporate law, the latter being supportive of the former, is replete with instances where relations have been converted into transactions. In fact, this was the earliest, and by far unequalled, contribution of corporate law to the world of finance, viz., and the ordinary share, which implies piecemeal ownership of the company. Ownership of a company is a relation, packaged as a transaction by the creation of the ordinary share. This earliest instance of securitisation was so instrumental in the growth of the corporate form of doing business, and hence, industrialization, that someone rated the it as one of the two greatest inventions of the 19th century -the other one being the steam engine. That truly reflects the significance of the ordinary share, and if the same idea is extended, to the very concept of securitisation: it as important to the world of finance as motive power is to industry. Other instances of securitisation of relationships are commercial paper, which securitises a trade debt.[6]

However, In India, the securitization concept is restricted to either assets based securitization (Mostly vehicle finance) and Mortgage based Securitization (Housing loan). The assets of such

[3] *M/s Transcore Vs.Union of India, AIR* 2007 *Supreme Court* 712.
[4] *Ibid.*
[5] SARFESI Act, 2002, Sec 2 Z.
[6] *Articles on Securitisation : Securitization a Primer*, Available at http://vinodkothari.com/seccont.

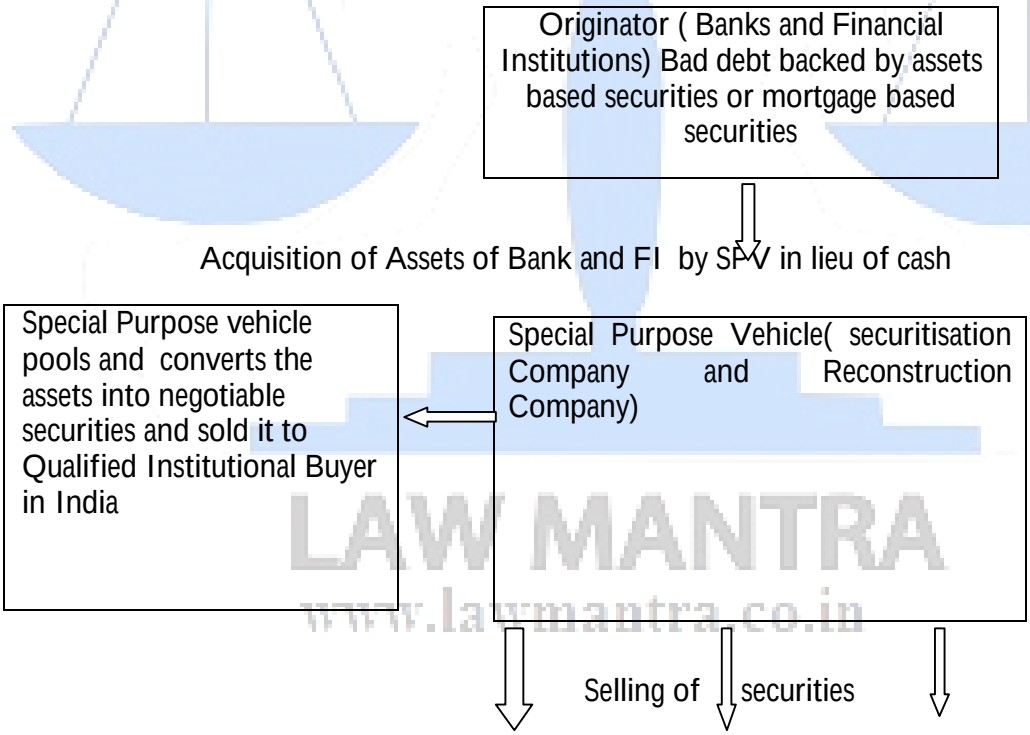
financing institutions are acquired by an SPV (Securitization / Reconstruction Company in India) and further such SC/RC coverts value of those assets into tradable securities. However, trading of such securities is further restricted to Qualified Intuitional Buyers.

Assets Reconstruction is defined as ""asset reconstruction" means acquisition of any securitisation company or reconstruction company of any right or interest of any bank or financial institution in any financial assistance for the purpose of realization of such financial assistance;"[7]

RBI guidelines on Guidelines on Securitisation of Standard Assets defines securitisation as "'Securitisation' means a process by which a single performing asset or a pool of performing assets are sold to a bankruptcy remote SPV and transferred from the balance sheet of the originator to the SPV in return for an immediate cash payment;"[8]

Securities and Exchange Board of India (Public Offer and Listing of Securitised Debt Instruments) Regulations, 2008, defines securitisation as" securitisation means the acquisition of debt or receivables by any special purpose distinct entity from any originator or originators for the purpose of issuance of securitised debt instruments to investors based on such debt or receivables and such issuance;"[9]

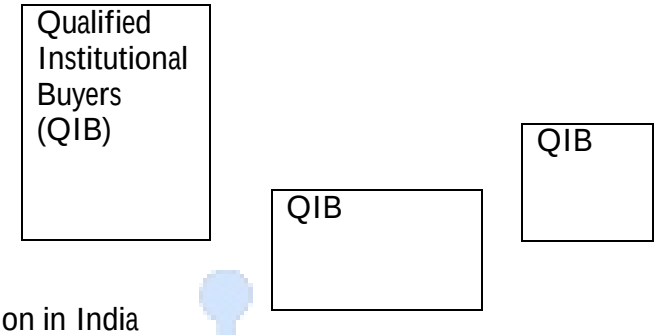
So, the concept of securitisation should be divided into two parts. First being Process of acquisition of assets of the originator (Bank and FI) by SPV (SC and RC) . In the first stage there is sale of a single asset or pooling and sale of a pool of assets by the owner of the assets ("Originator") to a 'bankruptcy remote' special purpose vehicle ("SPV") in return for an immediate cash payment.



[7] *Supra note 5* , Sec 2 b.

[8] Guidelines on Securitisation of Standard Assets, RBI No. 2005-06/294,DBOD.NO.BP.BC.60 / 21.04.048/2005-06, Avaialble at https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=2723&Mode=0.

[9] Securities and Exchange Board of India (Public Offer and Listing of Securitised Debt Instruments) Regulations, 2008, Regulation 2r.



Scheme of Securitisation in India

In the second stage repackaging and selling of the security interests representing claims on incoming cash flows from the asset or pool of assets to third party investors by issuance of tradable debt securities to the qualified institutional buyers.

Benefits of Securitisation

Securitisation offers many benefits to the originators (Bank and FI), Investors and the economy.

For Originators

1. Securitisation frees up an originator's capital by removing the assets from the balance sheet. This way, capital is now available for the origination of fresh assets with profitability potential.

2. Through Securitisation, an originator with a relatively lower credit rating, but with better rated cash flow would be able to borrow/raise funds against such higher rated cash flows at cheaper cost.

3. It improves the liquidity position of the originator as the future receivables are replaced by cash.

4. Securitisation can be used as a potent tool for re-balancing and re-distributing risks such as credit, market or liquidity risk or risk concentrations on the balance sheet of the originator.[10]

For Investors

For the investing parties, Securitisation offers a different set of benefits.

1. It provides another option for diversifying their debt portfolio.

2. It facilitates participation in relatively lower or higher risk portion of the cash flows, as per their own risk appetite.

3. Highly rated and credit enhanced securities add to the safety of investments as well as capital savings for the investors.

[10] Securitisation in India: Ambling Down or Revving up?, Inaugral Speech delivered by R. Gandhi, Deputy Governer at India (Inaugural Speech delivered by Shri R. Gandhi, Deputy Governor at "India Securitisation Summit 2015" organized by National Institute of Securities Markets (NISM) on July 14, 2015 at Mumbai), Avaialble on https://www.rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=964.

4. The presence of the 'Pool Servicer" provides certain additional assurance and safety.

5. Securitisation allows flexibility in structuring the timing of cash flows to one's needs.[11]

For Financial Markets

Securitisation provides alternate debt instruments in the financial markets and improves market liquidity. It widens the markets and allow entry of new players. It enhances return on capital, diversifies financial markets, and serves as an alternate route of funding. Securitisation diversifies credit markets as it breaks the process of lending and funding into several discrete steps, leading to specialization and economies of scale. Securitisation improves efficiencies in financial markets through risk diversification as the risks can be bundled and hived off and distributed among counterparties better equipped to manage these risks.[12]

Role of the Reserve Bank of India in Securitisation

The RBI being the regulator of Bank, financial institution and securitisation companies is expected to ensure proper growth and development of securitisation processes. The RBI has issued comprehensive guidelines in 2006 covering following important aspects related with securitisation.

1. Guidelines have defined broadly the concept related to securitisation as SPV, bankruptcy remote, credit enhancement, first loss facility, liquidity facilities, service provider and underwriting facilities.
2. True sale criteria have been defined broadly. It says that "The sale should result in immediate legal separation of the originator from the assets which are sold to the new owner viz. the SPV. The assets should stand completely isolated from the originator, after its transfer to the SPV, i.e., put beyond the originators as well as their creditors' reach, even in the event of bankruptcy of the originator. The originator should effectively transfer all risks/ rewards and rights/ obligations pertaining to the asset and shall not hold any beneficial interest in the asset after its sale to the SPV. An agreement entitling the originator to any surplus income on the securitised assets at the end of the life of the securities issued by the SPV would not be deemed as a violation of the true sale criteria. The SPV should obtain the unfettered right to pledge, sell, transfer or exchange or otherwise dispose of the assets free of any restraining condition. The originator shall not have any economic interest in the assets after its sale and the SPV shall have no recourse to the originator for any expenses or losses except those specifically permitted under these guidelines. There shall be no obligation to the originator to re-purchase or fund the re-payment of the asset or any part of it or substitute assets held by SPV or provide additional assets to the SPV at any time except those arising out of breach of warranties or representations made at the time of sale. The originator should be able to demonstrate that a notice to this effect has been given to the SPV and that the SPV has acknowledged the absence of such obligation. An option to repurchase fully performing assets at the end of the securitisation scheme where residual value of such assets has, in aggregate, fallen to less than 10% of the original amount sold to the SPV ('clean up calls') as allowed vide paragraph 10 can be retained by the originator. The originator should be able to demonstrate that it has taken all reasonable precautions to ensure that it is not obliged, nor will feel impelled, to support any losses suffered by the scheme or investors. The sale shall be only on a cash basis and the consideration shall be received not later than at the time of transfer of assets to the SPV. The sale consideration should be market-based and arrived at

[11] *Ibid.*
[12] *Ibid.*

in a transparent manner on an arm's length basis. Provision of certain services (such as credit enhancement, liquidity facility, underwriting, asset-servicing, etc.) and assumption of consequent risks/ obligations by the originators as specifically allowed in these guidelines would not detract from the 'true sale' nature of the transaction, provided such service obligations do not entail any residual credit risk on the assets securitized or any additional liability for them beyond the contractual performance obligations in respect of such services.[13]

3. The policy with respect to credit enhancement policy has also been laid down. [14]
4. It also provides accounting treatment for securitisation transaction and Prudential Norms for investment in the securities issued by SPVs.[15]
5. It also provides for Disclosures to be made by SPV, trustee and originators and due diligence work for securities transactions.[16]

In 2012, the guidelines were reviewed with the following important features:

1. Certain forms of Securitisation transactions like Re-Securitisation and Synthetic Securitisation are prohibited. Revolving credit facilities cannot be securitized / assigned. Single asset Securitisation is further prohibited. Securitisation / assignment of loans where both interest and principal are due only at maturity are not allowed. Credit enhancement is further prohibited.
2. The minimum holding period is prescribed and true sale criteria are made applicable to the assignment.
3. Minimum retention requirement is also prescribed. Loan for up to twenty four months, it is 5percent and for the loan beyond the tenure of 24 months, it is 10 percent. Outsourcing of credit decision is not allowed.
4. Non compliances of the guidelines will result into denying capital relief to the originators and the asset will be risk weighted at 1250%.[17]

RBI has notified the necessary guidelines from time to time for better use of securitisation by the banks, financial institutions and securitisation companies. In actual practice debt of smaller banks and NBFC's are purchased by larger banks. It has been rightly observed that " The band of originators and investors is narrow with NBFCs as the main originators and banks as investors. Public Sector Banks are mostly absent. Asset backed securitisation (ABS) is the largest securitisation class in India, driven by retail loan portfolio of banks. NBFCs like the Asset Finance Companies (AFC) operating in the SME and Transport financing segments and Micro Finance Institutions (MFI) are very active as originators. Though the market had begun since the year 2000, the GFC obviously has its repercussions in Indian market as well. It is reported that the Indian Securitisation market, which reached a high of 63,730 crore by March 2008 dwindled down to 28,800 crore in by March 2014. The micro finance companies play a larger role mainly due to their PSL underlying pools. Insurance, Pension and Mutual Funds can play an important role in the Indian securitisation market as they can invest long term and at the same time have the risk appetite, capacity and expertise for taking exposures to the lower tranches. However, the Pension Funds are not allowed to invest in securitisation PTCs and Insurance companies are allowed to invest in high investment grade AAA securities only. MFs are still hesitant to invest in the security papers due to past, pending court cases as well as lack of clarity on the tax implications

[13] *Supra* Note, Guideline 7.
[14] *Ibid.*
[15] *Ibid.*
[16] *Ibid.*
[17] Revisions to the Guidelines on Securitisation Transactions, Available at https://rbidocs.rbi.org.in/rdocs/content/pdfs/RGST210812_ANX.pdf.

for their investments. In the Finance Bill 2013, Mutual Funds were exempted from application of the Distribution Tax imposed on securitisation SPV's."[18]

Conclusion

Despite of better regulatory framework and efficient role played by RBI, the securitisation has not achieved as it was expected. Though the business of securitization and reconstruction companies have grown significantly, but it has not solved the problem of rising NPA, which is also posing serious threat to our banking and financial institutions. Restricting of securities receipt transactions among the banks and QIB, which is in fact larger banks and financial institutions have converted the process of securitization as a tool of financing weaker banks by larger banks for profit. To contribute to economic growth and financial stability, the conservative approach is required to be changed. With aggressive lending policy and competition amongst the bank, RBI can think of easing the norms for securitisation.

.

[18] *Supra* Note 10.