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Securitisation: choosing between knit-picking and fabric changing

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With the Lok Sabha passing the Finance Bill without rolling back the securitisation tax proposals contained in sections 115TA, 115TB and 115TC, the massive amount of money sitting in securitisation SPVs, with the banking system being the largest stakeholder, faces the tough choice of either picking up knits in the tax provisions and finding escape routes, or just changing the fabric. All this needs to be done shortly enough, over the next less than 30 days, as the new distribution tax sets into effectiveness from 1st June.

Hobson's choice

From 1st June, SPVs distributing income to the investors will have to pay distribution tax, which means, all distributions done on or after 1st June 2013 will come for the distribution tax. Some points may quickly be noted:

- The tax is apparently based on the date of distribution. Hence, even if distribution pertains to incomes of previous months, if it is distributed on or after 1st June, the tax is applicable. Normally, collections made in the month of May are distributed in June. This obviously necessitates *immediate* action to ensure that the income for the months of April and May does not come for unintended tax consequences.

- The total amount of PTCs issued in HY 2013 amounted to approx Rs 23000 crores, including originations by NBFCs and MFIs[1]. In all, approximately Rs 50000 crores worth PTCs will be outstanding as on 31st March 2013. Certainly, none of these transactions had anticipated a distribution tax when originally invested in. the tough question will now be – will the investors still be wiling to continue with their investments. There are at least 2 possible options:

    - Exit by transferring the investment to mutual funds, as mutual funds don't have the distribution tax. This would mean the investing bank will fall short of its priority sector requirements but then, there is still time to build up the priority sector book during the year. There are, of course, difficulties, if the investment was booked with hold-to-maturity classification.

    - Wind up the trusts, and hold the individual stakes by identifying loans in the pools and holding the same directly into their books. This would mean the trust vanishes, and the beneficial interest is converted into loans. Most trust deeds should have this provision, and even if not, trust law does permit beneficiaries to force the trustee to transfer trust property to the beneficiaries. Of course, if at all anyone chooses

[1] Housing finance companies' data is not included above.

this option, it is important to ensure that there is no common property among various investors, as this would definitely lead to formation of an AOP for tax purposes[2].

Neither of the options is easy, and, in fact, the whole exercise needs to be completed briskly enough to escape the distribution tax.

Knit-picking the provisions:

As one always does with tax provisions, one may always try the knit-picking option, that is, rummage through the tax provisions and see if it is possible to escape the sections. Escaping the section will not mean escaping tax questions – in fact, the very genesis of sections 115TA to 115TC is the tax uncertainty created by some tax officers proposing to tax securitisation SPVs as representative assessees. Hence, escaping sections 115TA – 115TC would mean going back to that uncertainty. Taxes are sometimes described as certain as death, but a death by surprise may be better in a way than a death sentence.

Knit-picking, luckily, is possible, with required amount of intellectual play. For instance, sec 115TC defines a special purpose vehicle as one which is defined in a regulated under the RBI guidelines for securitisation of performing assets. In addition, the SPV has to satisfy such conditions as may be prescribed. Prescription is commonly done by way of rules. The rules will be framed and notified only after the Act comes into force: hence, that is opaque as of now. But what if the SPV does not satisfy one such condition? Obviously, the entire chapter, that is, sections 115TA-115TC shall be inapplicable in such a case.

The securities of the SPV as referred to as “debt securities”. The 2006 Guidelines of the RBI loosely referred to pass through certificates as debt securities. Pass through certificates can no way be said to be debt securities.

Sec 115TC of the Income-tax Act is limited to an SPV being a trust. However, SPVs do not have to be trusts. In fact, corporate or LLP forms of SPVs are quite common in many countries. Para 8 of the 2006 Securitisation Guidelines clearly permits SPVs to be partnership, trusts or companies. This author has quite often contended that the trust form is not necessarily the best form for organising SPVs, as trusts have unlimited liabilities, while companies have limited liability.

[2] There already are some tax rulings holding securitisation vehicles to be AOPs.

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Charting future course of action

We have elaborately written and spoken on the fact that securitisation is not just a way of investing in India – it is the way banks build their priority-sector assets. Most securitisation in India revolves around the priority-sector qualification. For last 2 years, there has been no mutual fund investment in securitisation transactions: the entire securitised assets have been picked by banks, and all of it is supposedly priority-sector-lending compliant. So, going forward, that need still remains. The simpler option one may think of is to revert to direct assignments. Direct assignment route was the product of the 2006 RBI guidelines; 2012 Guidelines forced stakeholders to look back at the "securitisation" option. Now, the market may have to look back at direct assignments. Compared to structured finance principles applying to "securitisation", direct assignment is primitive. Originator credit enhancements are ruled out by the RBI, and third party enhancers currently do not exist. Given this, the cost of a direct assignment is much higher than that of securitisation. In addition, direct assignment requires loan-by-loan due diligence, and loan-based accounting, which, for many investors, is a difficult option.

If securitisation option becomes difficult, it is a serious issue for the banks. However, it is almost an existential issue for transport finance companies. To a very large extent, the growth of NBFCs in India has piggy-backed on the priority sector norms, through the securitisation route. One single transport finance company supplied more than 1/3rd of the total securitisation volume in 2012-13. If securitisation becomes difficult or costly, the costs are obviously passed on to the originators. And this has a direct impact on the profits and growth of NBFCs.

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