COVERED BONDS

VAISH
ASSOCIATES
ADVOCATES
Corporate, Tax and Business Advisory Law Firm

OVERVIEW

- Covered bond is a debt instrument that is secured by a pledge of a segregated pool of assets (called "**cover pool**") which are on the balance sheet of the issuer.
- The bond is paid back from the issuer's cash flow rather than from the cash flow of the assets in the cover pool themselves. The assets in cover pool only act as additional security cover.
- Investors have recourse to the assets in the cover pool that secures or "covers" the bond if the issuer/originator becomes insolvent.

ABS/MBS VERSUS COVERED BONDS

- Unlike mortgage-backed securities, a covered bond remains on the issuer's balance sheet. The cash flow to the investor happens from the issuer's cash flows not from the assets, whereas the cash flows to the investor in ABS/MBS happen from the cash flows from the underlying assets.
- An investor of covered bond has recourse against both the issuer and the cover pool. It is a dual recourse bond.
- The non-performing assets in the cover pool can be replaced.
- Unlike ABS/MBS, the prepayment risk in covered bonds is entirely with issuer

SECURED BONDS VERSUS COVERED BONDS

- Covered bonds give the bond-holders bankruptcy-proof access to the assets of the issuer.
- This can come from legislation which grants covered bond-holders special rights (European countries have special legislation to isolate cover pool and protect bond-holders from the bankruptcy process)
- In jurisdictions, where there is no specific legislation, by creating a structure created by the issuer (using SPEs and transfer of assets) to attain bankruptcy proofing for the bond-holders. In this case, it must be ensured that the SPE cannot be consolidated with the issuer/originator. Therefore, the SPE must have the ability to make decisions independently without control of the Issuer of covered bonds.

GLOBAL LEGISLATION

- The countries that have implemented covered bonds legislations are: Australia, Austria, Belgium, Bulgaria, Canada, Cyprus, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy Luxembourg, Netherlands, New Zealand, Norway, Poland, Portugal, Singapore, Spain, Sweden, Switzerland, Turkey and United Kingdom.(Source : European Covered Bonds council)

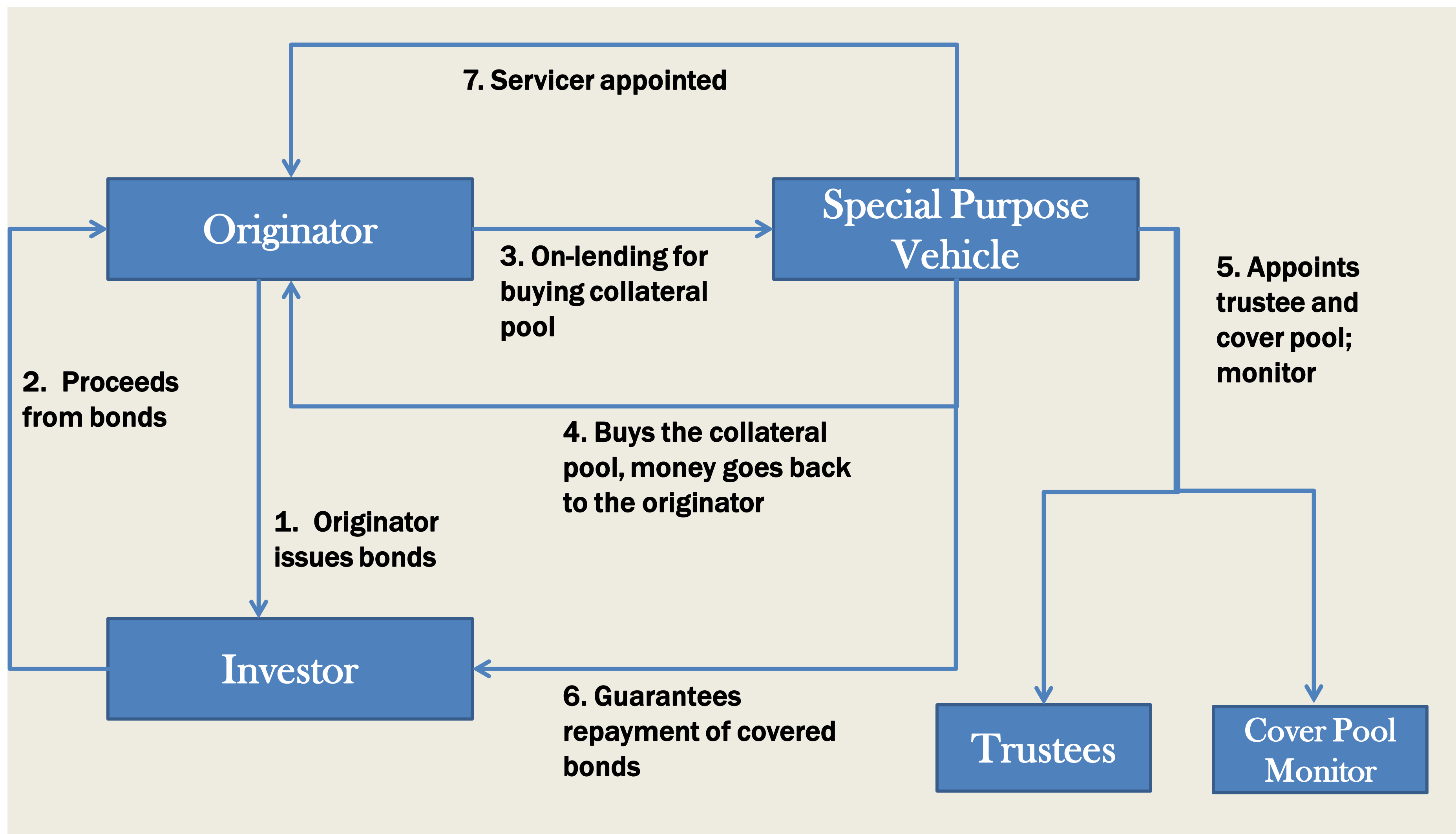
- In these countries, the special laws mandate that cover pool will be kept outside the bankruptcy estate of the issuer. Hence, assets become bankruptcy-remote.

ATTAINING BANKRUPTCY REMOTENESS THROUGH STRUCTURING

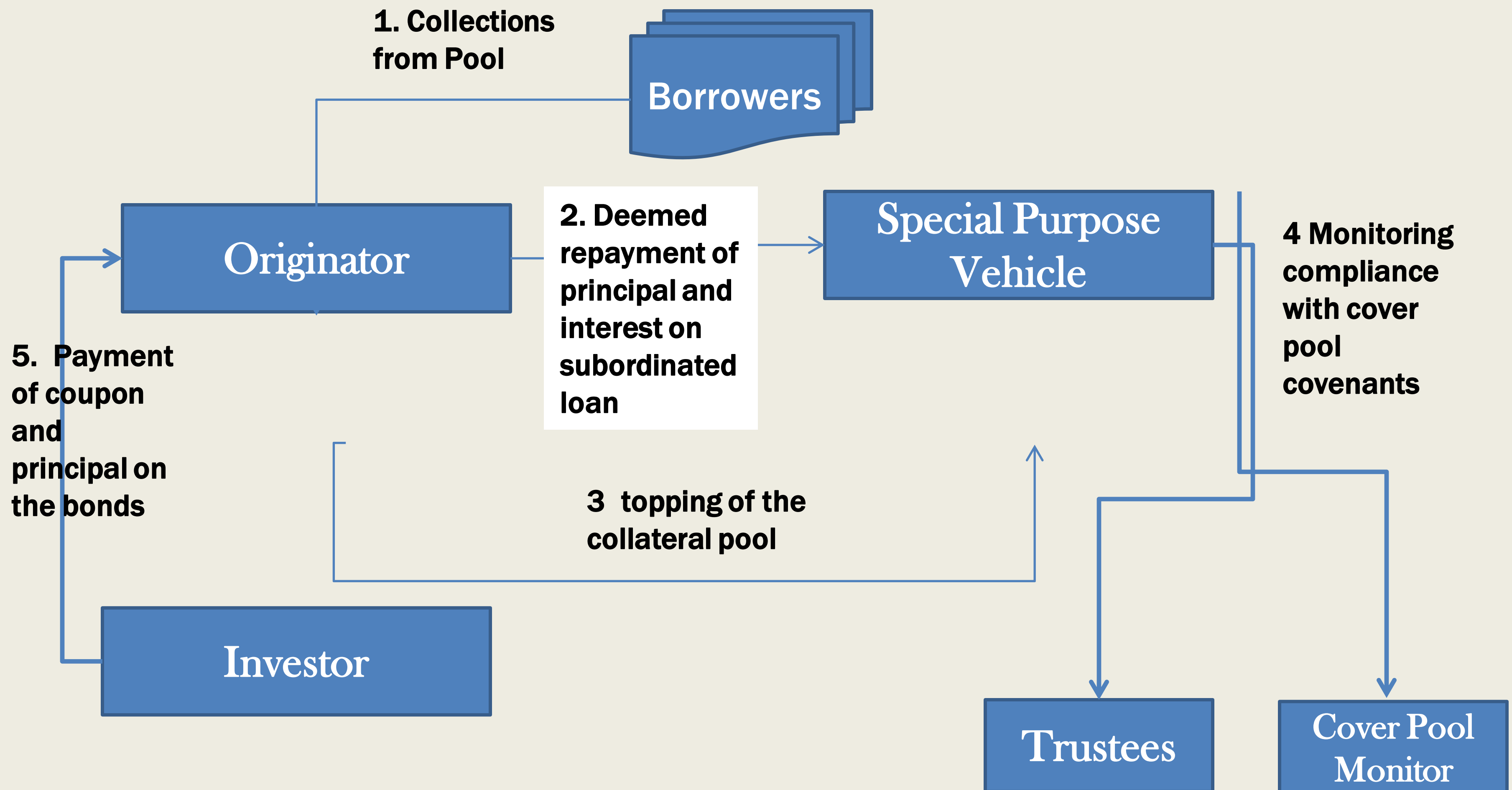
The entities involved here would be

- the Issuer
- the SPE
- the Cover Pool Monitor and
- the Investors

COVERED BONDS WITH SPV STRUCTURE: AT INCEPTION



SPV STRUCTURE: CASHFLOWS DURING THE TERM



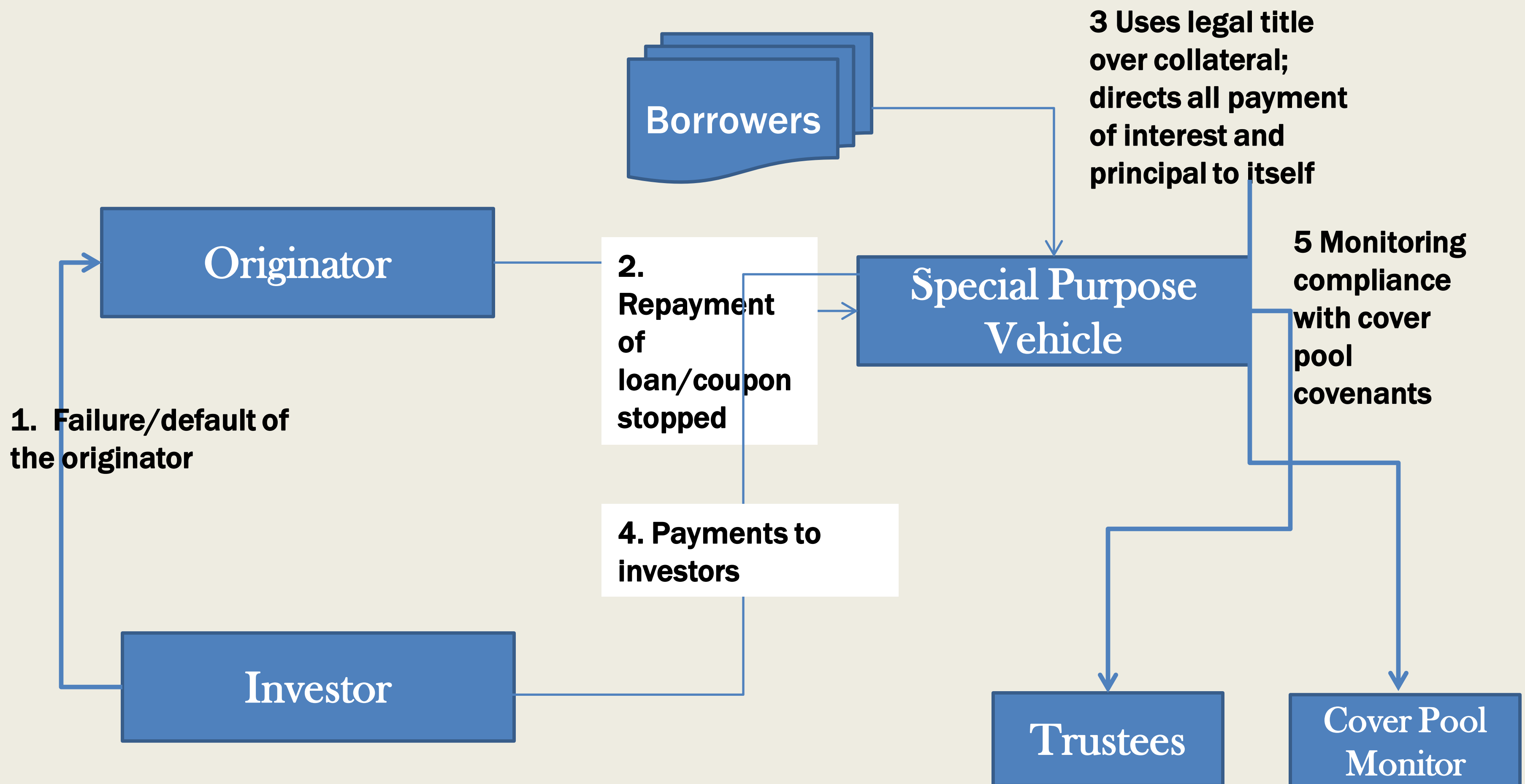
STRUCTURE

- SPV acquires legal title over the cover pool. However, the cover pool still remains on the balance sheet of the issuer as this is full recourse transfer of the cover pool to the SPV.
- Issuer liable to top up the cover pool to the extent of defaults / repayment/prepayment
- SPV gets its funding by way of a subordinated loan from the issuer. This subordinated loan gets amortised from out of the cover pool collections

STRUCTURE

- SPV creates a charge over the cover pool in favour of bondholders
- The SPV appoints the security trustee and the cover pool monitor to protect the interest of the bondholders. Cover Pool Monitor ensures the maintenance of credit enhancement levels at all times.
- Bond holders have full recourse to Issuer. Issuer repays the bonds from out of its own cashflows. Upon default by Issuer bond holder is paid out of the cover pool

SPV STRUCTURE: IN CASE OF DEFAULT



INTER-CORPORATE LOAN BY ISSUER TO SPE

- The loan to the SPE can be a subordinated loan.
- This is to ensure that the claims of bondholders take priority over the claims of the Issuer against the SPE.
- Upon default of the Issuer, the loan re-payment shall standstill

LEGAL AND REGULATORY ISSUES IN COVERED BONDS

- True Sale of Cover Pool
- Recourse under SARFAESI for cover pool
- Stamp duty
- Companies Act, 2013
- Debenture Regulations
- Deposit Regulations
- RBI directions
- Documentation

LEGAL ISSUES IN COVERED BONDS

True Sale of Cover Pool

- Ensure arms' length distance between Issuer and SPE
- Avoid common directors/trustees between Issuer and SPE
- Issuer should not exercise any form of control over the SPE
- If there is default in any loan in cover pool the same should be assigned back to the Issuer and the Issuer substitutes the same by assigning a similar loan. This should be evidenced by deed of assignment
- Alternatively, overcollateral can be provided based on historical default rates in the pool and excess collateral can be assigned back to Issuer at the end of the term of the bonds.

CONCEPT OF TRUE SALE- TRANSACTION BETWEEN THE ISSUER AND SPE

Two possibilities:

- First, if there is a sale of assets by Issuer to SPE, the assets in question will go off the books of the Issuer and the consideration will be recorded on the books. The transfer can result in profit or loss, which has to be recorded.

- Second, if the transaction is not treated as a sale, then the transfer could be deemed as an advance of funds by the SPE to the Issuer secured by the payment stream from the cover pool. The SPE could then be treated as an unsecured creditor of the Issuer but not an ownership interest, in the payment stream from cover pool. In such a case, the Issuer's bankruptcy would automatically result in a stay of all actions by creditors to foreclose on or otherwise obtain property of the Issuer and the SPE may lose its right to cover pool.

KINDS OF RECOURSE

Recourse for Collection

- Here, the Issuer warrants that the asset will perform in accordance with its terms. This is a case where Issuer has a contingent obligation to pay the SPE only if the underlying cover pool defaults. <u>This does not turn a sale into a loan and therefore, we would prefer this method of sale of cover pool to the SPE. Incidentally, this is permitted by RBI.</u>

Economic Recourse

- Here, the Issuer warrants a return to the buyer of its investment plus an agreed upon/fixed rate of yield, calculated in advance, such rate being unrelated to the asset's payment terms. In economic recourse, the SPE's recourse for its return is not conditioned upon default of the cover pool, but upon the mere passage of time. A put option in the hands of the SPE can for example make it look like a loan.

In other words, what we are saying is that if "recourse" is a contingent and secondary liability, but not a primary liability, then it is a valid true sale. Re-characterization is appropriate only if there is economic recourse.

HOW TO UNDERSTAND "RISK OF LOSS"

- It is not always true that a legal sale does not occur unless the SPE assumes the "risk of loss" associated with the asset. SPE may not bear risk of loss.
- When a negotiable instrument like a cheque is transferred by way of indorsement and delivery, there is a full recourse against the transferor. the presumption that an indorser warrants the terms of a negotiable instrument serves that purpose.
- The recourse however only arises when the document/cheque is not honored by the primary obligor.
- Using this argument, a sale with contingent recourse, but not economic recourse is valid in law as a true sale.
- While at some level there may be a difference between a negotiable instrument and a receivable, a rule of law that would promote sales of negotiable instruments with recourse but effectively prohibit such sales of other assets by applying a "risk of loss" standard would make little sense.

ACCOUNTING STANDARDS IN INDIA (IND AS 109 FINANCIAL INSTRUMENTS)

As per Ind AS 109, when an entity transfers a financial asset, it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset.

In this case:

- if the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity shall de-recognize the financial asset and recognize separately as assets or liabilities any rights and obligations created or retained in the transfer.
- if the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity shall continue to recognize the financial asset.
- if the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, the entity shall determine whether it has retained control of the financial asset. In this case:

  (i) if the entity has not retained control, it shall derecognize the financial asset and recognize separately as assets or liabilities any rights and obligations created or retained in the transfer.

  (ii) if the entity has retained control, it shall continue to recognize the financial asset to the extent of its continuing involvement in the financial asset.

[Ind AS 109 paragraph 3.2.6]

ACCOUNTING STANDARDS IN COVER BONDS PERSPECTIVE

- In transferring a loan to a SPE, the main risk is that the primary obligor will default. If this sale is with recourse, then the risk of loss is retained by the Issuer. This means that under Ind AS 109, de-recognition is not possible and the loan will remain as a financial asset in the books of the Issuer.
- The Issuer also retains control over the loan, by way of servicing and prepayment, which implies that under Ind AS 109, de-recognition may not be possible.

LEGAL ISSUES IN COVERED BONDS

Recourse under SARFAESI for cover pool

- If the primary obligor of the loans forming part of cover pool defaults, then since the legal title is in the name of the SPE, the SPE cannot proceed against the primary obligor under SARFEASI, but instead it can recover money from the bank by seeking "recourse".
- After SPE seeks recourse, the bank may thereafter reverse the sale of the relevant loan and proceed against the primary obligor under SARFAESI.

LEGAL ISSUES IN COVERED BONDS

Stamp Duty

- Stamp duty at time of issuance of bonds. If debenture is a marketable security (capable of being sold in any stock market) stamp duty may be attracted under section 27 of Indian Stamp Act – 0.05% per year of the face value of debenture subject to cap of 0.25% or Rs 25 lakhs which ever is lower. Document can provide that debentures shall not be listed or bought or sold on floor of stock exchange.
- Stamp duty shall be applicable on the "instrument" that transfers legal interest in the receivables
- Mortgage may be retained with the issuer as a trustee for the SPV
- Transfer of mortgages at nominal stamp duty may be explored but may be administratively difficult due to registration issues.

LEGAL ISSUES IN COVERED BONDS

Companies Act, 2013

- Comply with section 71 of Companies Act, 2013
- Rules 14 of Companies (Prospectus and Allotment of Securities) Rules, 2014 relating to private Placement.
- Offer document in PAS-4 to be filed with ROC
- Special resolution of shareholders once in a year for all offers of debentures for the year
- Offer to not more than 200 persons in aggregate in financial year (excluding QIBs and employee stock options) – not applicable to registered NBFCs and HFCs
- Record private placement offers to be maintained in PAS-5 to be filed with ROC within 30 days of offer letter
- Return of allotment in PAS-3 to be filed within 30 days

LEGAL ISSUES IN COVERED BONDS

Rule 18 of Companies (Share Capital and Debenture) Rules, 2014 ("Debenture Rules")

Section 71 of Companies Act, 2013 requires creation of debenture redemption reserve by Issuer. Under Debenture Regulations (a) Banking companies and All India FIs exempted, and (b) For registered NBFCs and HFCs DRR nil for privately placed NCDs and 25% for public issues

Clause 7 (c) - Further, every company required to create DRR must deposit before 30th April, 15% of debentures maturing during the ensuring year in notified securities – to be used for redemption only

Clause 1(a) – term of NCD not to exceed 30 years for infrastructure and 10 years for other companies.

Clause (1) (c) – For secured debentures, issue shall be secured by charge on (a) any specific movable property of company, (b) any specific immovable property and interest therein. For NBFC charge can be created on any movable property of company.

LEGAL ISSUES IN COVERED BONDS

Deposit Regulations

- Does not apply to NBFCs and Banks
- NBFCs covered by NBFC Acceptance of Public Deposits (RB) Directions, 1998 – exemption from "public deposits" for secured debenture and debentures issued in accordance with RBI guidelines with a maturity more than one year and having the minimum subscription per investor at Rs.1 crore and above
- Companies other than Banks/NBFCs - Exemption available to any bond or debenture secured by first charge or a charge ranking pari passu with first charge on any assets. Exemption also available to amount received by a company from any other company.

LEGAL ISSUES IN COVERED BONDS

Issuance of NCD (Reserve Bank) Directions, 2010

- Will apply if term of bonds is upto one year
- These directions cover debt instruments issued by a corporate (including NBFC) with original or initial maturity up to one year and issued by way of private placement
- Corporate means a company as defined in the Companies Act (including NBFCs) and a corporation established by an act of any legislature
- Eligibility conditions – tangible net worth of Rs 4 crores, working capital or term loan from Banks/all India FIs, borrower account is classified as standard asset.
- Rating requirement, appointment of debenture trustees, disclosure requirements

LEGAL ISSUES IN COVERED BONDS

RBI guidelines on private placements of NCDs (Maturity more than one year) by NBFCs – guidelines do not apply to tax exempt bonds

- Minimum subscription per investor Rs 20,000
- Two categories (a) maximum subscription of less than Rs 1 crore, (b) minimum subscription of Rs 1 crore and above per investor
- Limit of 200 subscribers for every financial year for issuance of NCDs with maxm subscription of less than Rs 1 crore and such subscription shall be fully secured
- No limit on number of subscribers for issuances with minimum subscription of Rs 1 crore and above and security optional. Unsecured debentures will not be treated as deposits under NBFC Acceptance of Public Deposit (RB) Directions
- An NBFC (excluding CIC) shall issue NCD only for deployment on own balance sheet and not to facilitation resource requests of group entities.

LEGAL ISSUES IN COVERED BONDS

Documentation

- Information Memorandum – PAS 4
- Deed of assignment of Cover Pool
- Servicer Agreement in respect of Cover Pool
- Deed of charge/mortgage over the Cover Pool to be created by SPE in favor of Bond-holders
- Trustee Agreement/Cover Pool Monitor Agreement

RING FENCING THE COVER POOL

- Sale of the covered pool by Issuer to SPV by valid deed of assignment

- Stamp duty to be payable on the deed of assignment. Capped at Rs 1 lakh in a few states

- SPV creates a fixed charge over the cover pool in favor of bond holders

- As the cover pool legally belongs to the SPV, none of the creditors of the originator will have any right over the collateral pool

BANKRUPTCY REMOTENESS

- The contractual documents will provide that in the event of bankruptcy of the Issuer, trustees will ensure that the proceeds from the cover will go directly to the bondholders

- Section 37 of Maharashtra Value Added Tax Act, 2002

  any amount of tax, penalty, interest, sum forfeited, fine or any other sum, payable by a dealer or any other person under this Act, shall be the first charge on the property of the dealer or, as the case may be, person.

- Similar provisions under Central Excise Act, Customs Act, Employees' Provident Funds and Miscellaneous Provisions Act, 1952, Employee's Compensation Act, 1923

BANKRUPTCY REMOTENESS

- Section 531 of Companies Act, 1956 – Fraudulent Transfer- any transfer within 6 months before commencement of winding up could be deemed a fraudulent transfer in the event of company being wound up
- Section 531A of Companies Act, 1956 – Avoidance of voluntary transfer –Transfer of property within one year before presentation of petition for winding up shall be void against the liquidator. Exceptions transfer in good faith and for valuable consideration.
- Section 529A of Companies Act, 1956 – Overriding Preferential Payments- security of every secured creditor shall be deemed to subject to a pari passu charge in favor of workmen.

WHAT HAPPENS WHEN THE ISSUER GOES BANKRUPT

- In the event the Issuer files for bankruptcy, the security provided by SPE will become enforceable
- The SPE will be called on to make payments to bondholders
- The SPE will re-direct the cash flows from the assets to itself
- The claims of the bondholders are therefore paid from the cover assets by the SPE
- Thereafter the bondholders will join the unsecured creditors pool to sue the Issuer for the balance, if any

OTHER LEGAL ASPECTS

TAXATION

In the securitization model, income from the securities will be taxed in the hands of the securitization trust at the time of distribution and such income is exempt in the hands of the investors.

In covered bonds, the income will be taxed in the hands of the investors as interest income, similar to a simple loan transaction, while the Issuer can treat the interest payments as a revenue expense.

SEBI

Foreign portfolio investors can invest in listed bonds

These bonds can be listed under SEBI (Issue and Listing of Debt Securities) Regulations, 2008

EXISTING LEGAL FRAMEWORK

- No statute or regulation prohibits or restricts issue of covered bonds.
- Encouragement can be provided by introducing statute or regulation which declares bankruptcy remoteness for the cover pool. However, players are better off without excessive restrictions and regulations similar to securitization regulations.

CONCLUSION

Banks and NBFCs may consider issuing covered bonds in the following circumstances –

- Funds required to be raised urgently in case of loans not meeting MHP criteria
- Assets purchased by NBFCs from other entities which cannot be securitized or assigned
- Assets purchased by banks from other entities which cannot be securitized
- Assets purchased by banks from other entities and not held for three years which cannot be assigned
- Loans with bullet repayment of both principal and interest
- Single Asset loans
- Where banks / NBFCs do not wish to comply with minimum retention requirements for securitization or assignment

OUR OFFICES

NEW DELHI

1st & 11th Floors, Mohandev Building,
13 Tolstoy Marg, New Delhi -110001
INDIA
Phone: +91 11 49252525
Fax: +91 11 23320484
Email: delhi@vaishlaw.com

MUMBAI

106, Peninsula Centre,
Dr. S. S. Rao Road,
Parel, Mumbai - 400012 INDIA
Phone: +91 22 42134101
Fax: +91 22 42134102
Email: mumbai@vaishlaw.com

GURGAON

803, Tower A, Signature Towers,
South City-I, Nation Highway 8,
Gurgaon – 122001 INDIA
Phone: +91 124 4541000
Fax: +91 124 4541010
Email: gurgaon@vaishlaw.com

BENGALURU

305, 3rd Floor, Prestige Meridian-II,
Building No. 30, M.G. Road,
Bengaluru - 560001 INDIA
Phone: +91 80 40903588/89
Fax: +91 80 40903584
Email: bangalore@vaishlaw.com

© 2013 Vaish Associates Advocates. All rights reserved.