Integration of financial markets and capital markets

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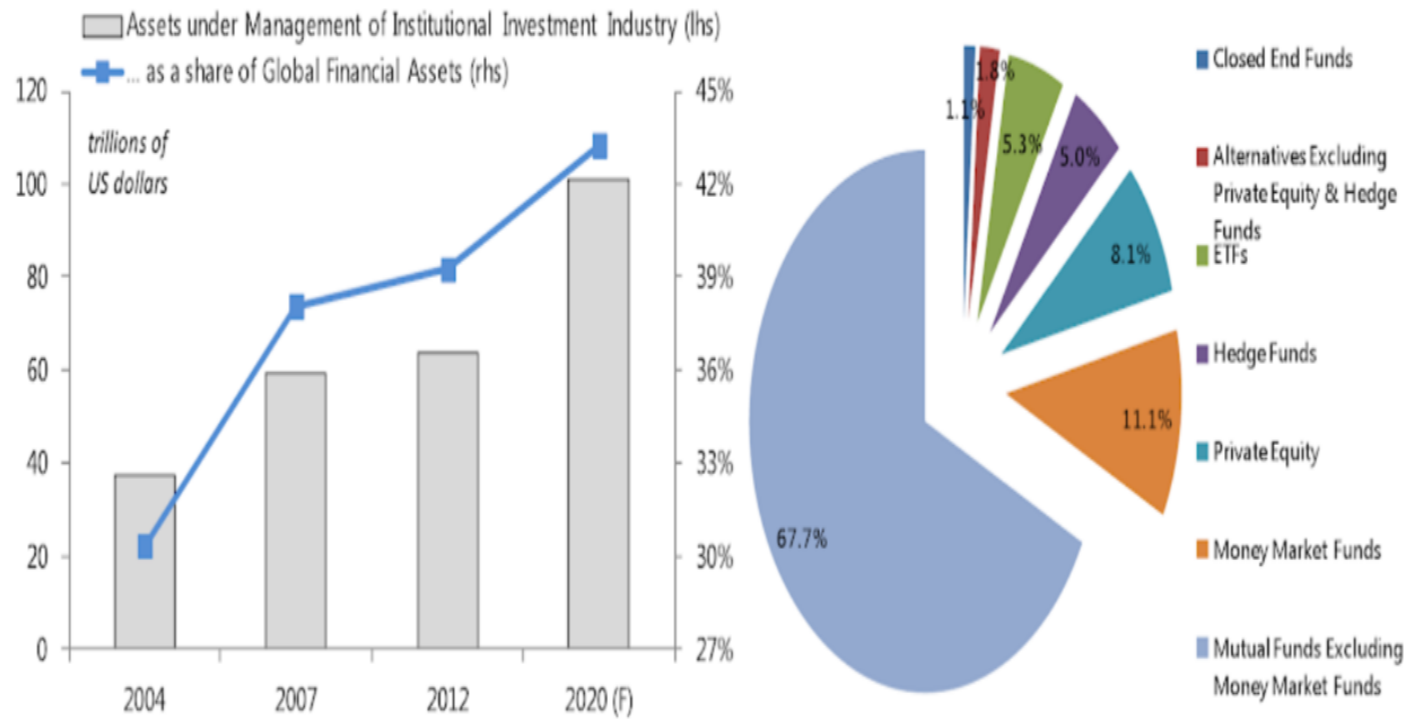
Different types of collective investment vehicles

Why collective investment vehicles?

- Pooled vehicle that allows investors to invest in a specific asset(s)
- Key element:
  - Pooling of money
  - Investors' interest usually represented by units
  - An investment strategy, or investible asset(s), income or activity
  - Investment, and not operating activity
  - Usually tax transparent
  - May provide liquidity either directly by the fund or by traded units
- Examples of CIVs:
  - Mutual funds and ETFs
  - Hedge funds
  - Venture capital funds
- The size of CIVs or institutional assets under management is over $ 70 trillion, and approx 38% to 40% of global financial assets

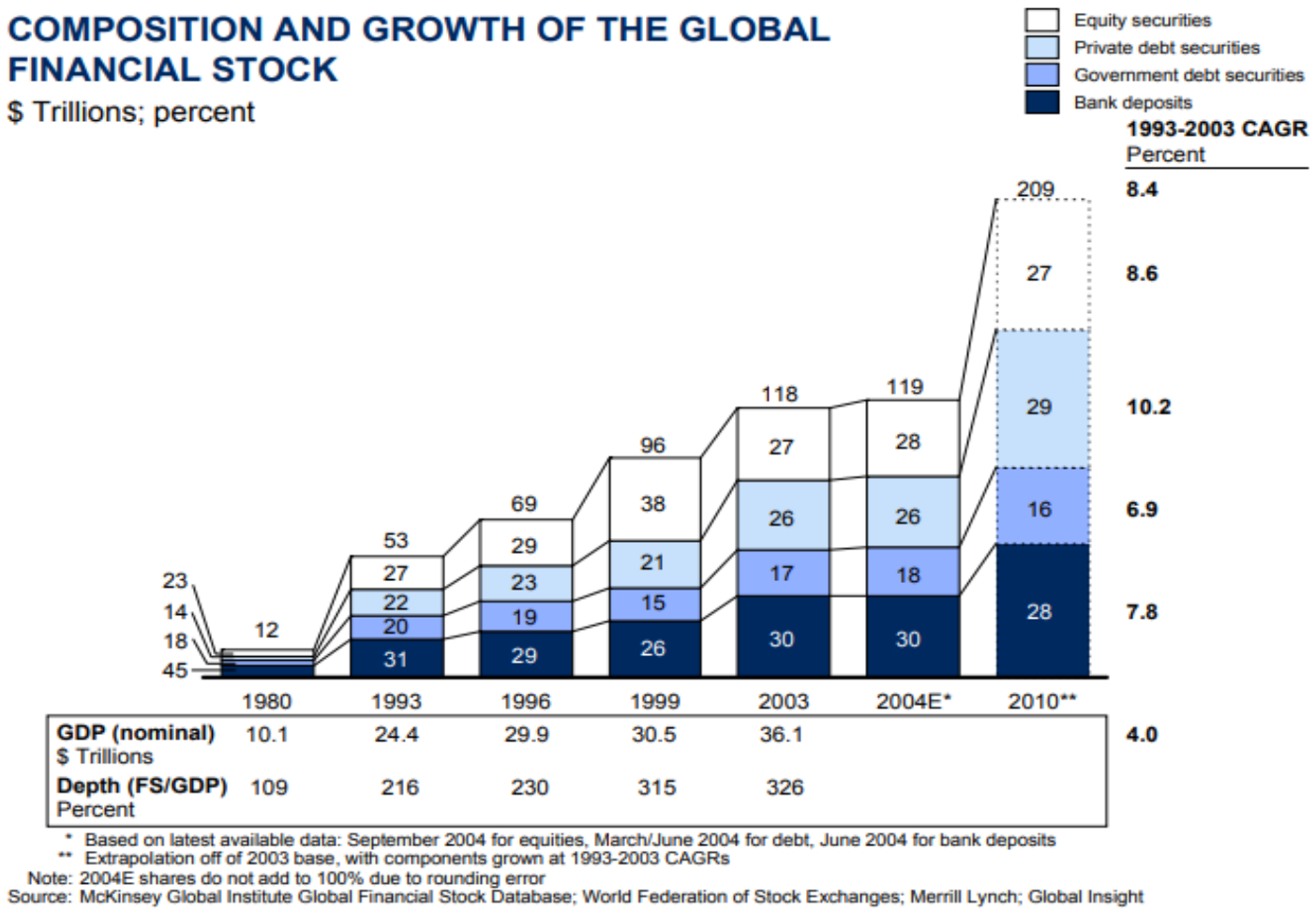
Figure 1. Institutional Assets under Management (left) and Investment Vehicles (right)



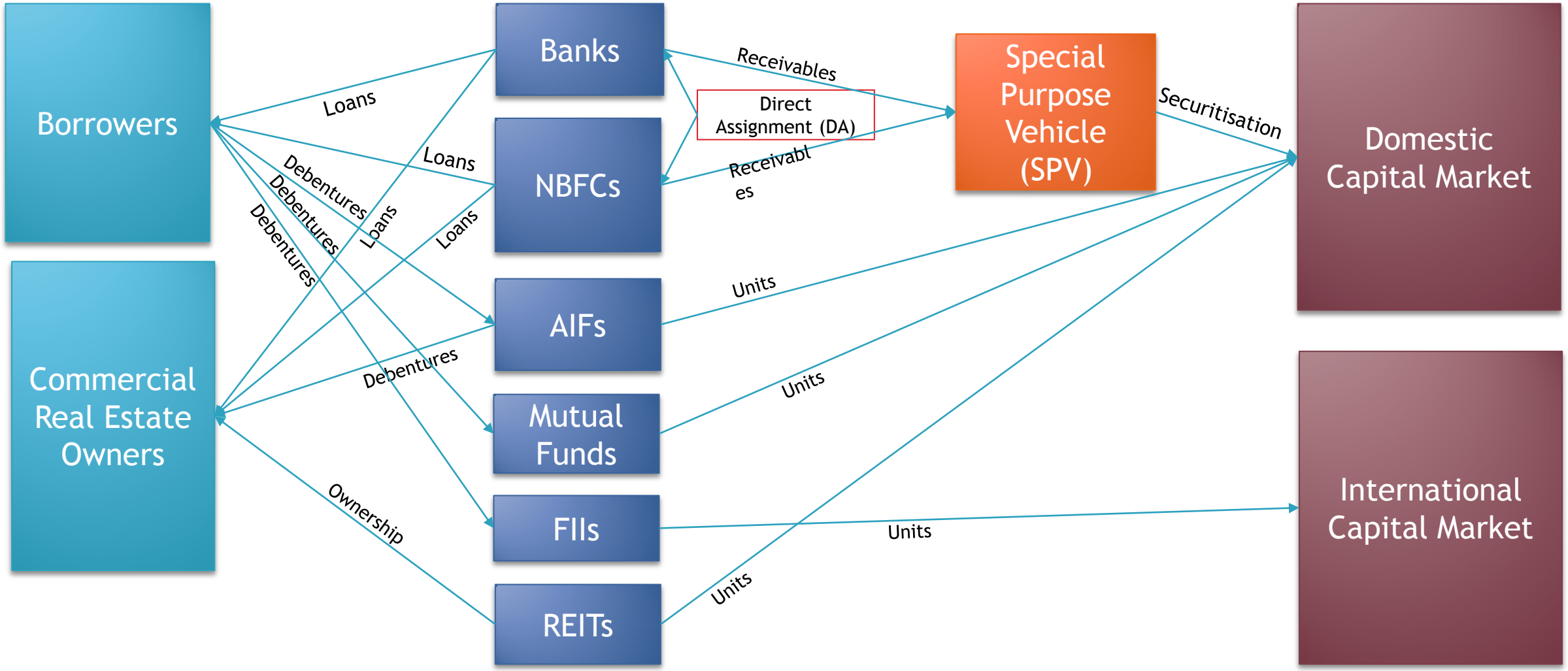
Source: Pensions and Investments/Towers Watson (2014), Barclay Hedge, Preqin, ETFGI, Bloomberg, Author's estimates.
Notes: Figures in right hand panel are based on the relative share of assets in worldwide collective investment vehicles.

Is institutionalization of funds reflection of disintermediation

- The traditional financial intermediary model [depository bank] globally seems to be becoming less commonly used method of holding financial assets
- Financial intermediation is coming under attack in 2 ways:
  - Institutional investors or CIVs
  - Financial Technology in form of P2P lending, direct collective ownership of resources, resource sharing, etc



INTEGRATION OF FINANCIAL MARKETS WITH CAPITAL MARKETS



Integration of Financial markets with Capital Markets: *Pros and Cons*

Pros

Capital markets are more efficient, as they reduce intermediation costs

- As evidence, the loads charged by debt mutual funds are lower than Overheads with banks

Financial intermediaries indicate accumulation of risks, and more prone to contagion

Financial intermediaries have capital requirements; hence, they need to service capital

Pricing of risk premium is better by capital markets, as capital markets represent collective wisdom

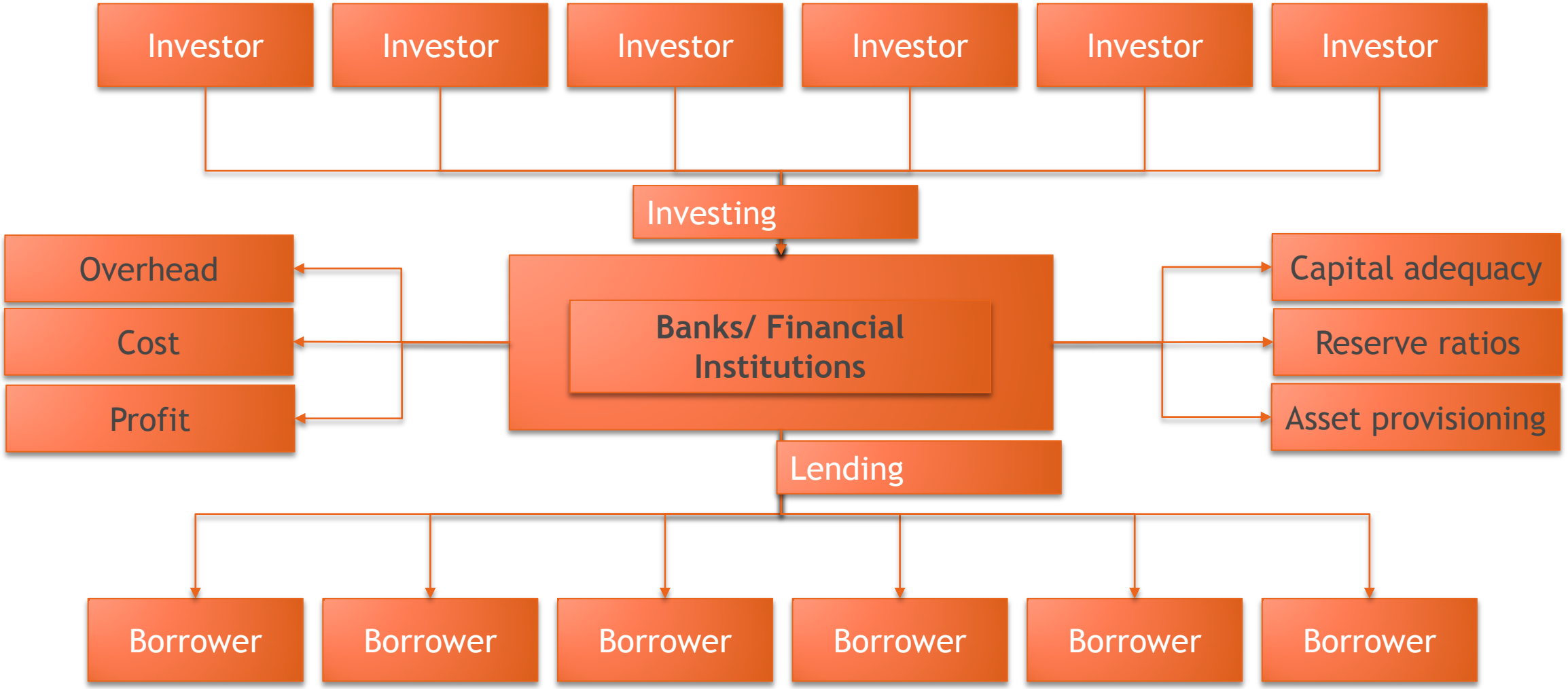
Cons

Effectiveness of financial market supervision

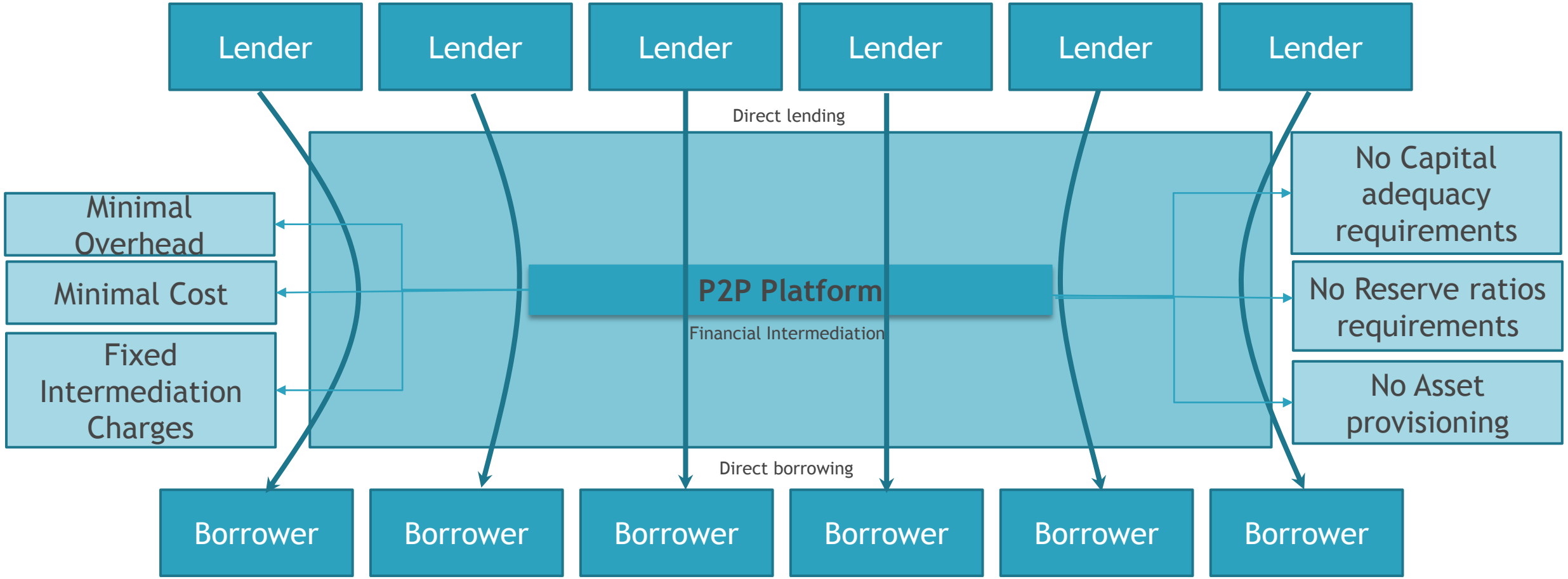
Many institutional investors are managed vehicles with auto triggers – no possibility of managing

Since capital market access by borrowers is in addition to bank finance, increase in leverage

Traditional financial intermediation model



P2P Lending model

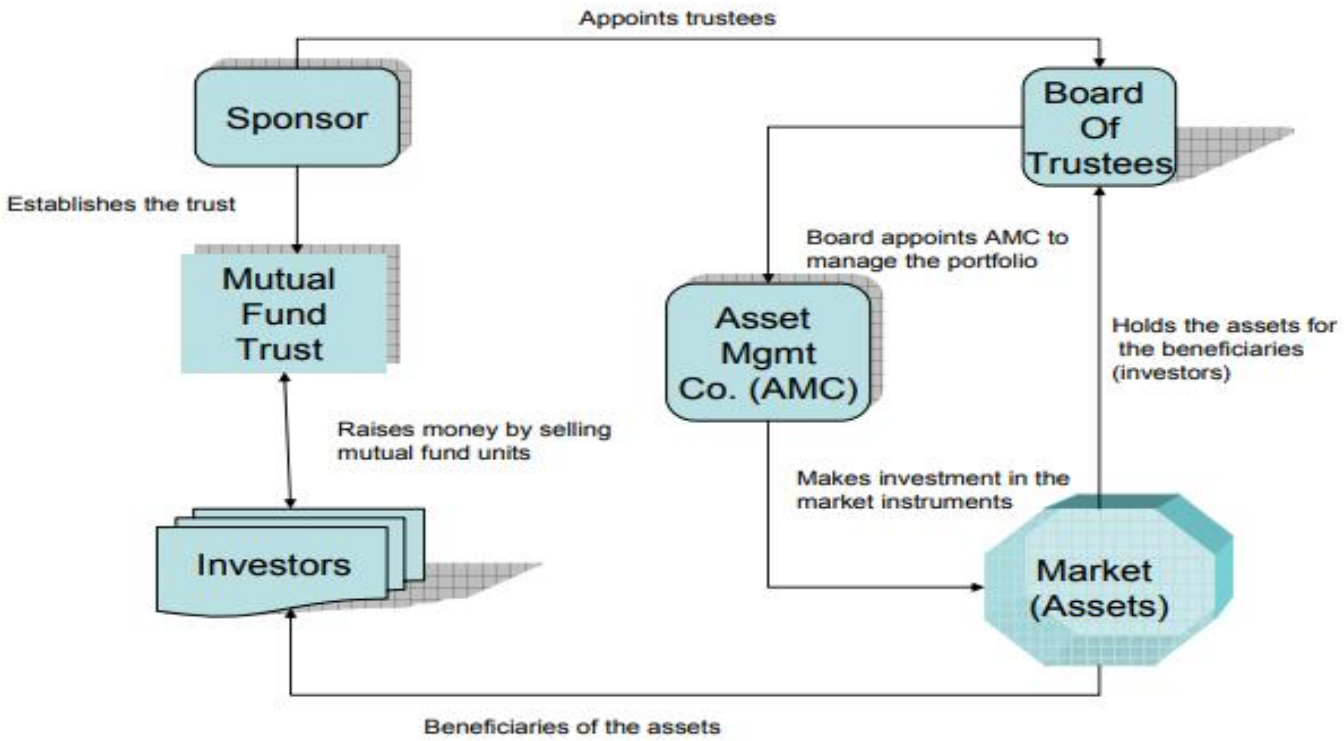


Types of Investment Vehicles in India

- Mutual Funds and ETFs
- Alternative Investment Vehicles
  - Category I AIF
  - Category II AIF
  - Category III AIF
  - Foreign Venture Capital Investors
- Collective Investment Schemes
- Foreign Portfolio Investors
- REITS and InvITs

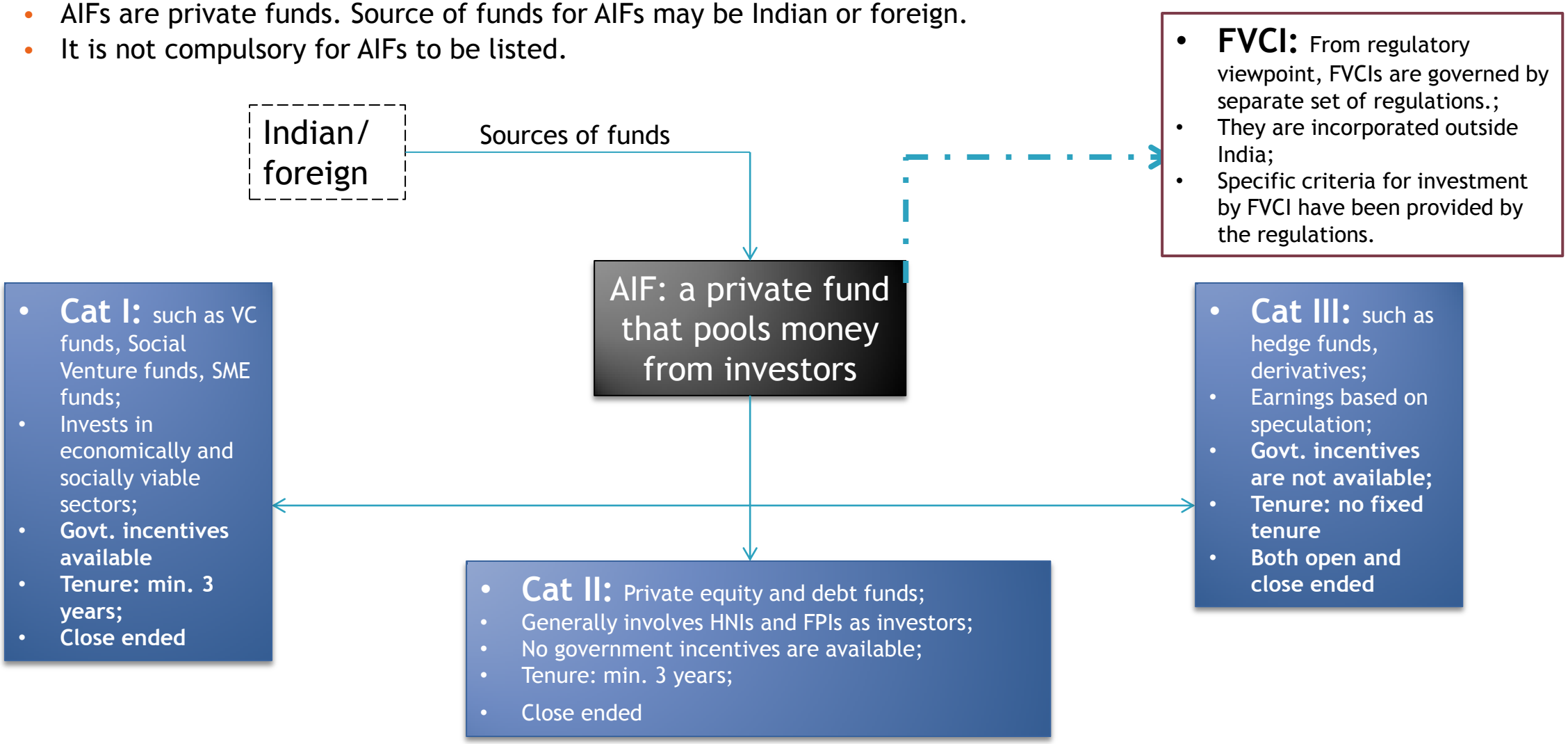
Mutual Funds

Mutual Funds – A trust that pools together resources of investors, in order to invest in capital markets. Against the pooling of funds by investors, the trust issues 'units', thereby making them part owners of the assets of the mutual fund scheme. It offers the ease of investment and diversified return, with the services of a professional asset manager. Low entry size. .



AIFs

- **AIFs:** Based on a structure similar to MFs, Alternative Investment Funds pool together funds from investors and issues units to them. An AIF can be in form of a company/ LLP/ body corporate/ trust.
- AIFs are private funds. Source of funds for AIFs may be Indian or foreign.
- It is not compulsory for AIFs to be listed.

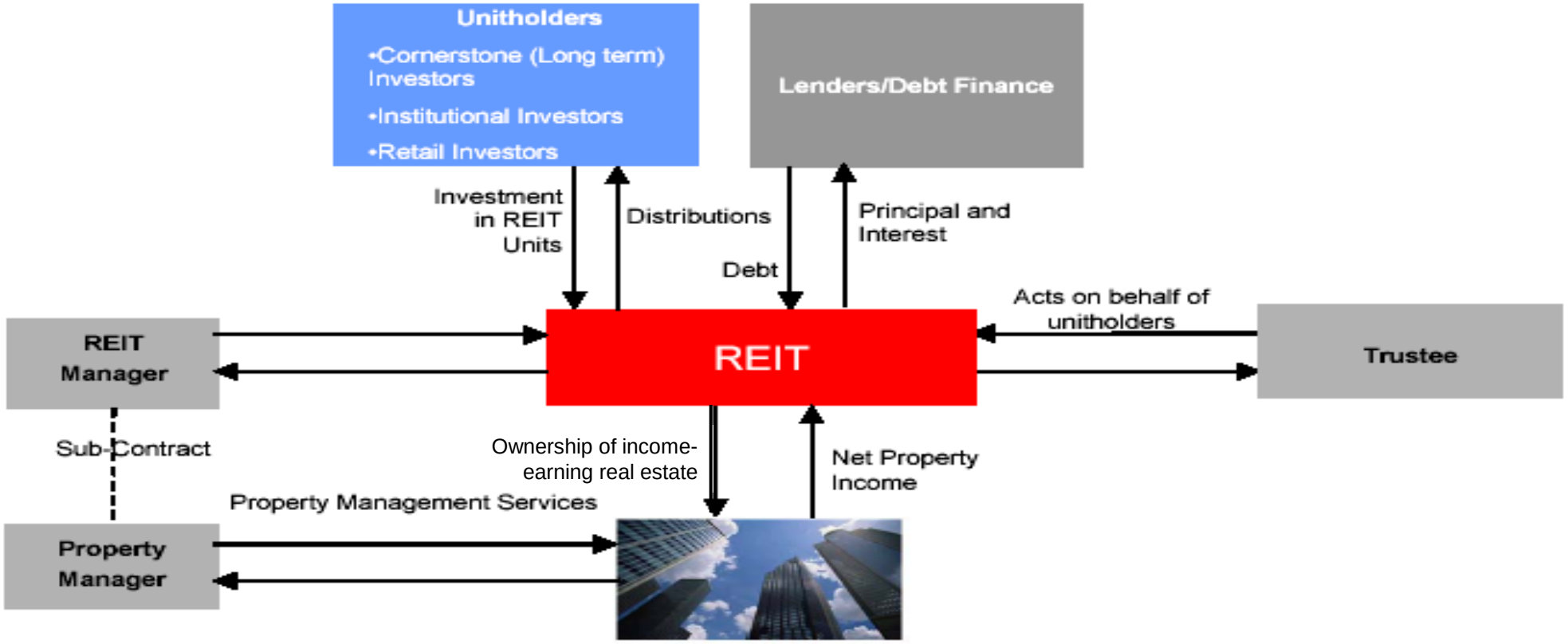


REITs and InvITs

- **REITs**:
  - REITs were the product of US tax legislation in 1960
  - With the specific idea of permitting investors to invest in a tax transparent, collective vehicle for investing in income-yielding real estate
  - A US-type REIT is
    - Closed-end, and usually listed
    - Tax transparent, subject to conditions, especially distribution of at least 90% of taxable income
    - Investors get the advantage of investing in a real asset, with low correlation with financial assets
  - REITs have emerged as a very powerful mode of investing in commercial real estate
- Many countries have enacted specific laws to permit REITs

- **InvITs**:
- Largely an Indian innovation
- Inspired by the REIT model, for investing in infrastructure assets
- Several collective investment vehicles envisaged in India for investment in infrastructure projects
  - Infrastructure debt funds
  - Infrastructure bonds
  - NBFC – IFCs
  - However, these supply debt to infrastructure projects
- An InvIT supplies equity, and not debt, to an operational infrastructure assets
- Listed and traded instrument
- Limited use of leverage

Structure of REITs/ InvITs



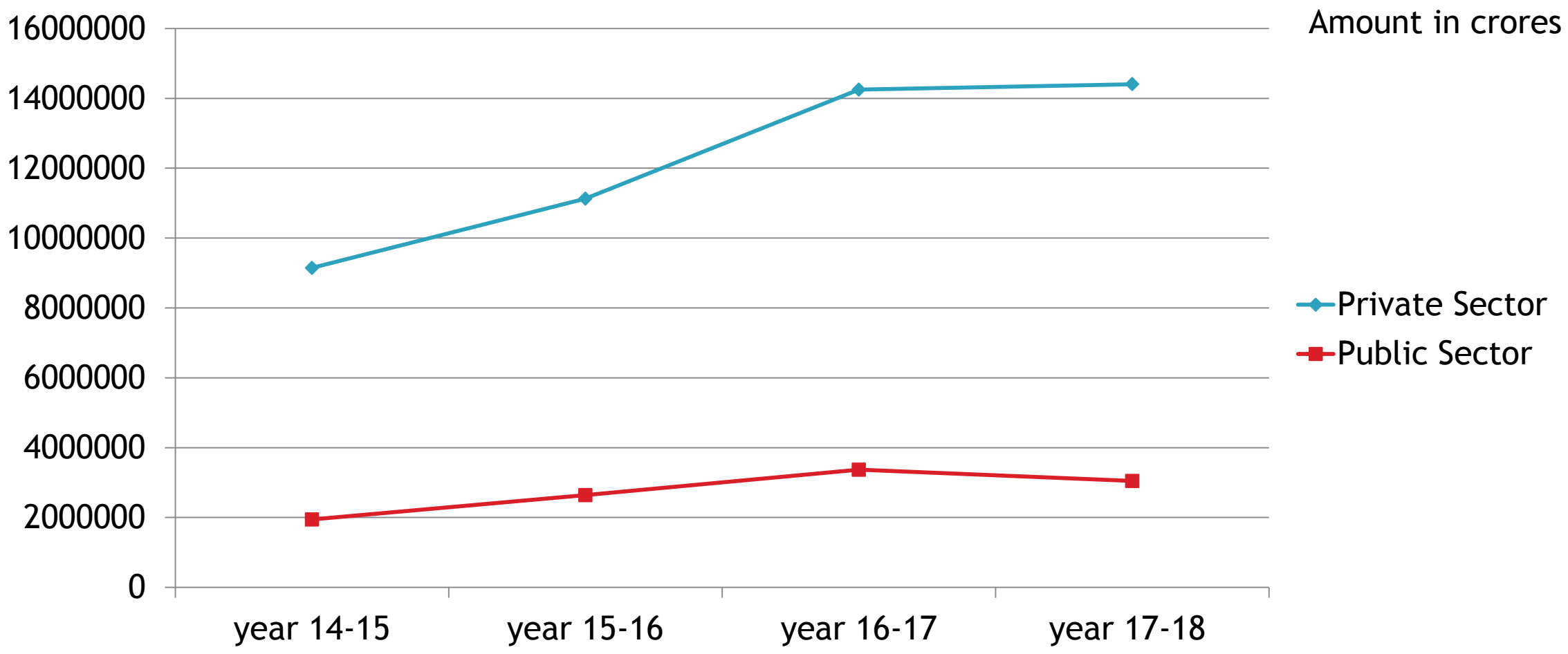
Structure of InvITs is similar to REITs, except that the investment is in **"Operationalized projects in the infrastructure sector"**

Growth of investment vehicles in India

- *Mutual Funds*
- *AIFs*
- *REITS and InvITs*
- *Comparison with GDP*

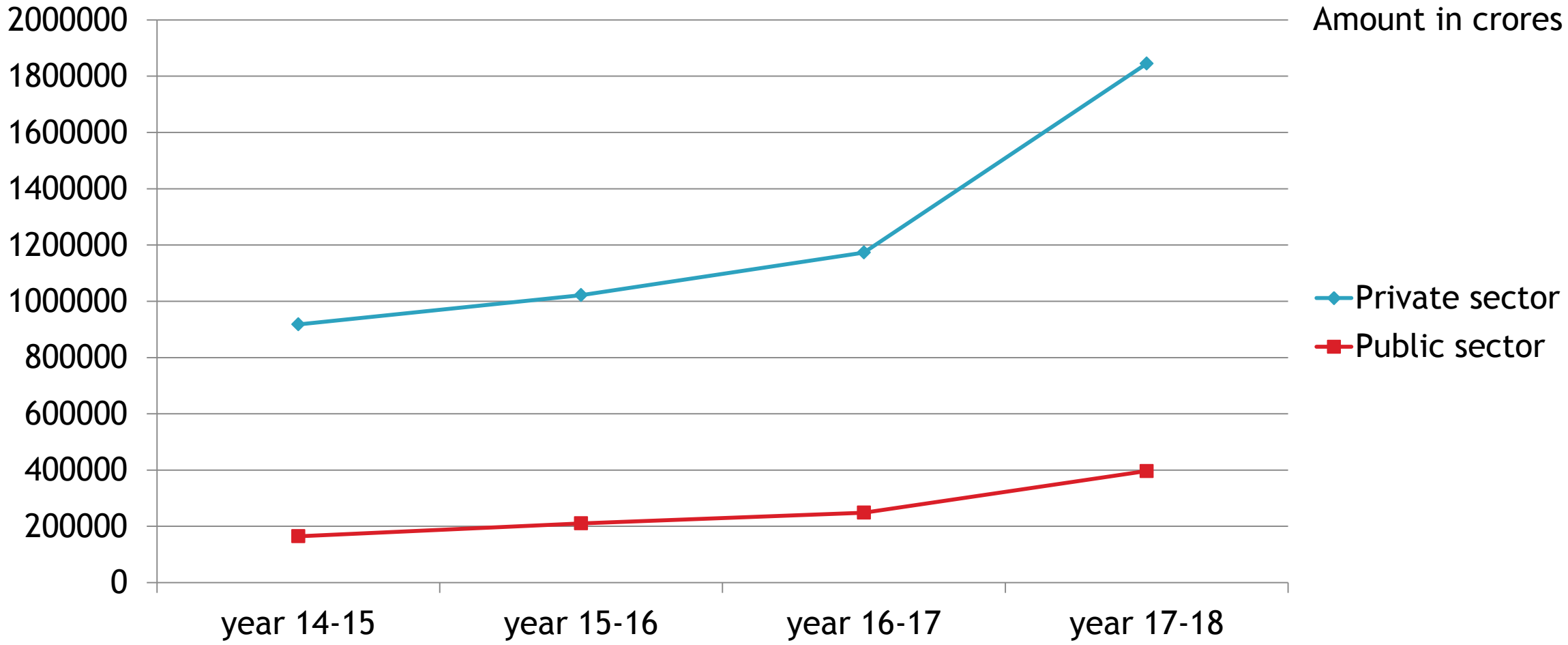
Growth of mutual funds

Status of Funds Mobilised (for the period April 1, 2014 to January 31, 2018)



Source: https://www.sebi.gov.in

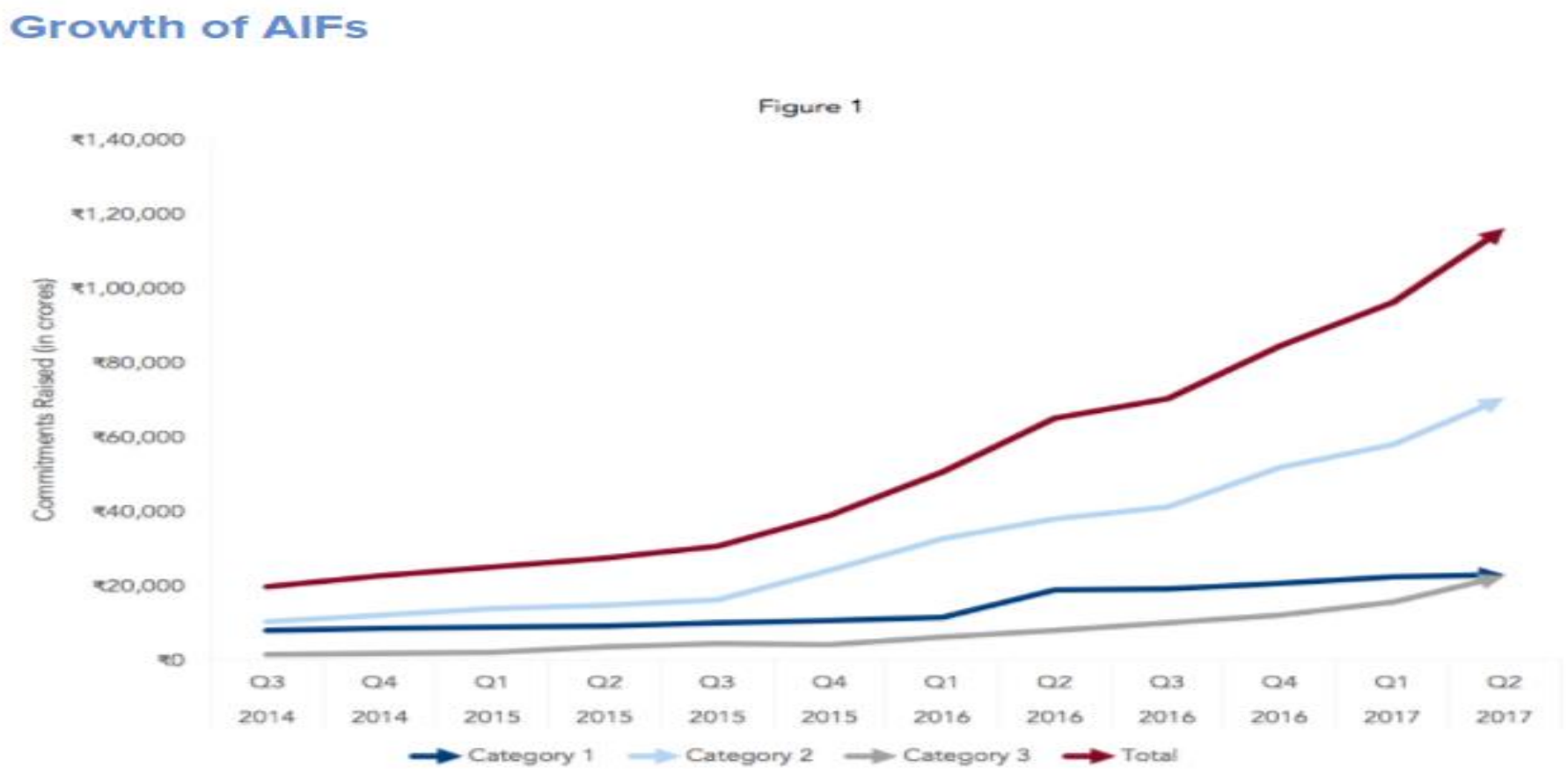
Cumulative position of Net Assets (for the period April 1, 2014 to January 31, 2018)



Source: https://www.sebi.gov.in

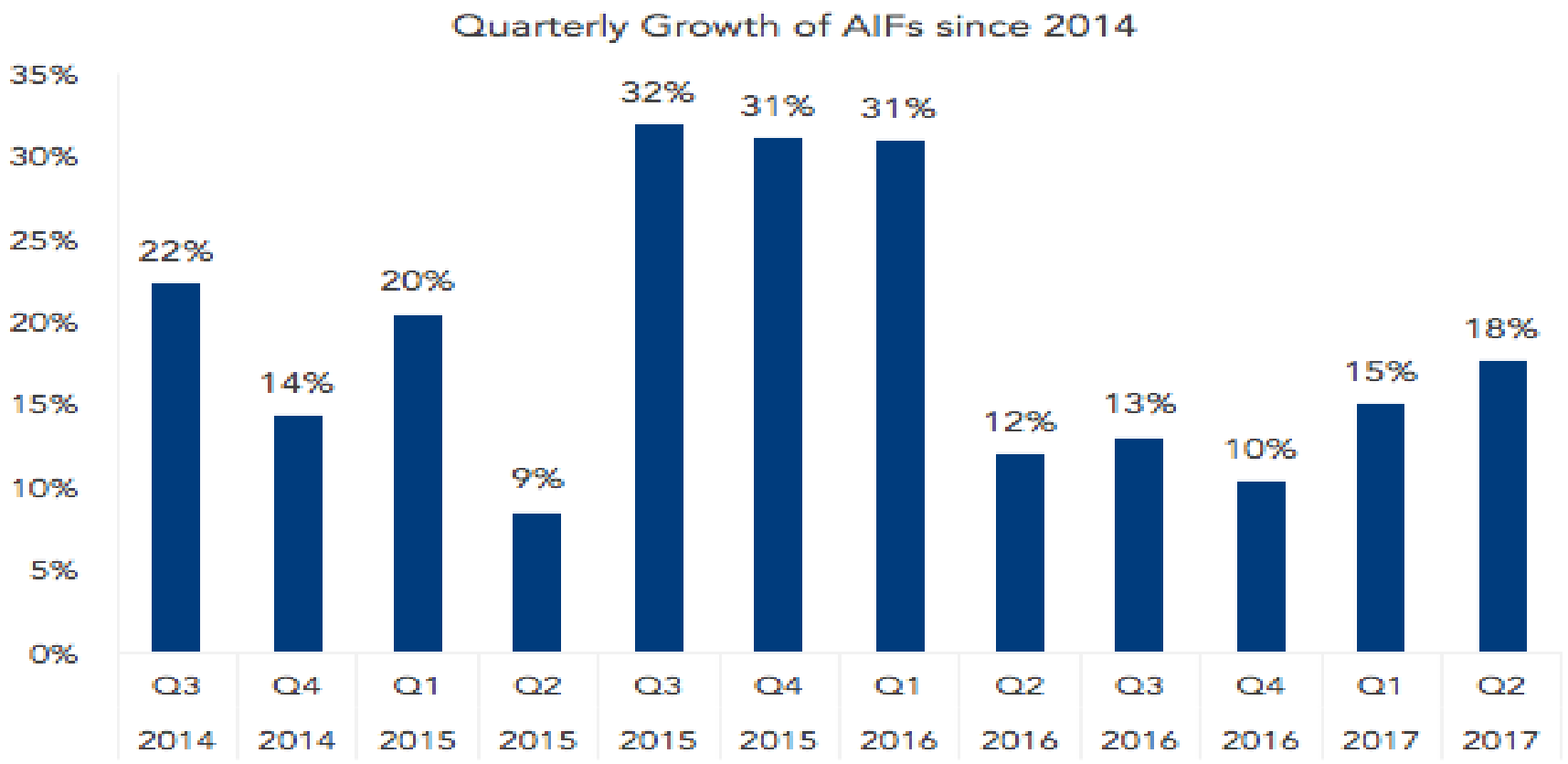
Growth of Alternative Investment Vehicles (AIFs)

Growth of AIFs in India 1/2



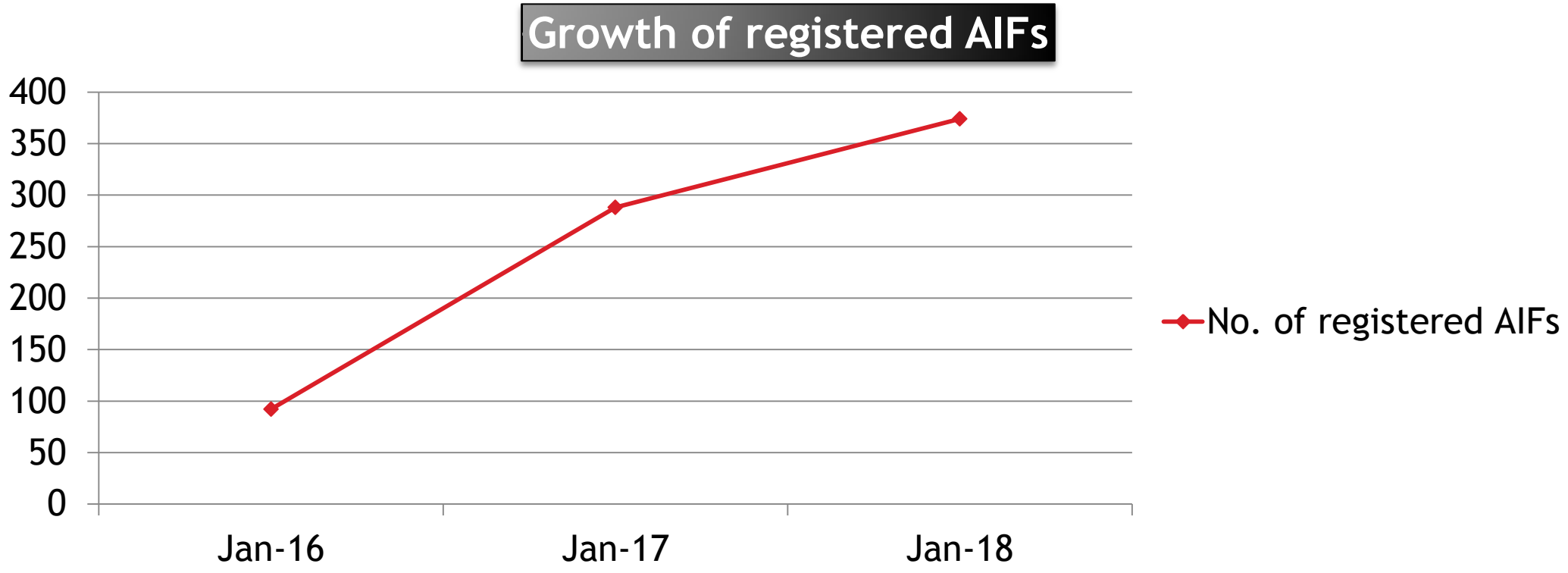
Source: http://riskadvisorsinc.com/alternative-investment-funds-take-off-style

Growth of AIFs in India 2/2



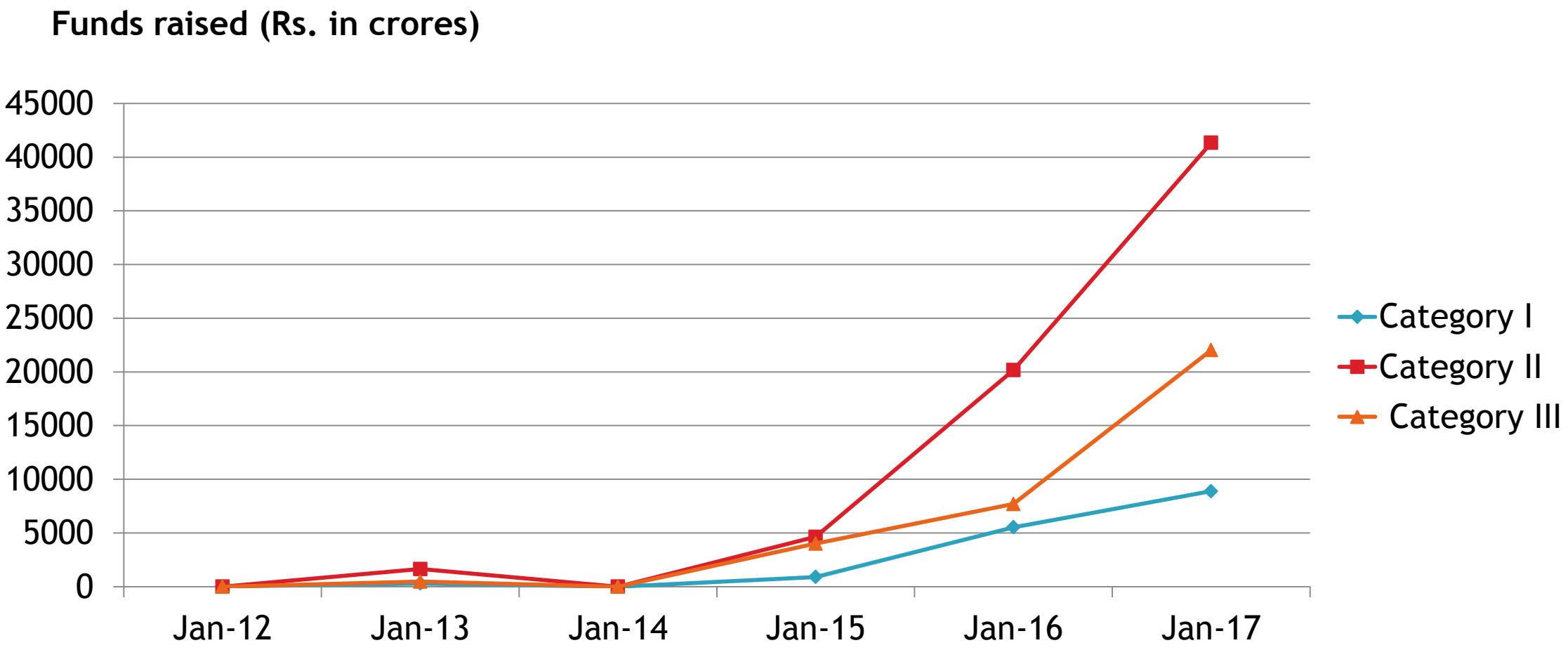
Source: http://riskadvisorsinc.com/alternative-investment-funds-take-off-style

There are **total 374 AIFs** registered under SEBI, as per the records available on the website of SEBI, as on 21st Feb, 2018.



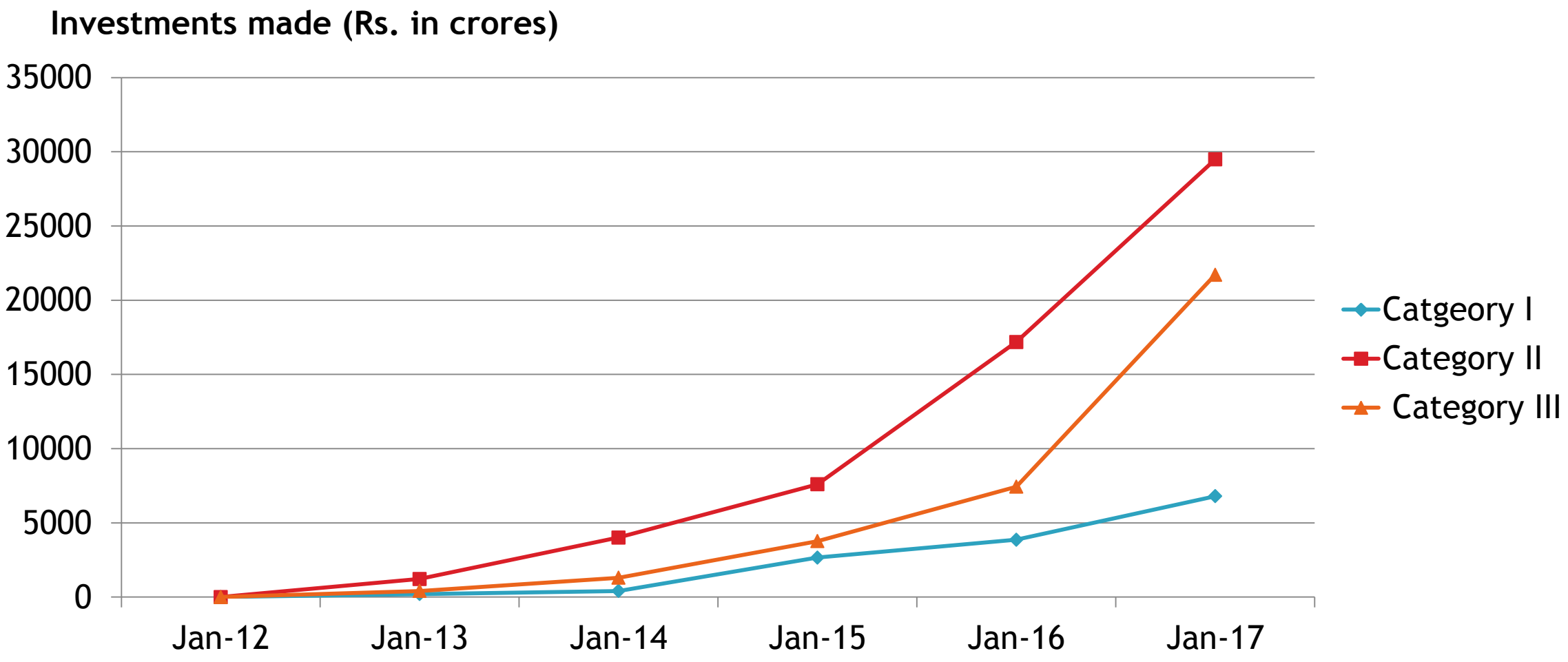
**Date as available on public domain*

Category wise figures 2/3



Source : https://www.sebi.gov.in/statistics/1392982252002.html

Category wise figures 3/3

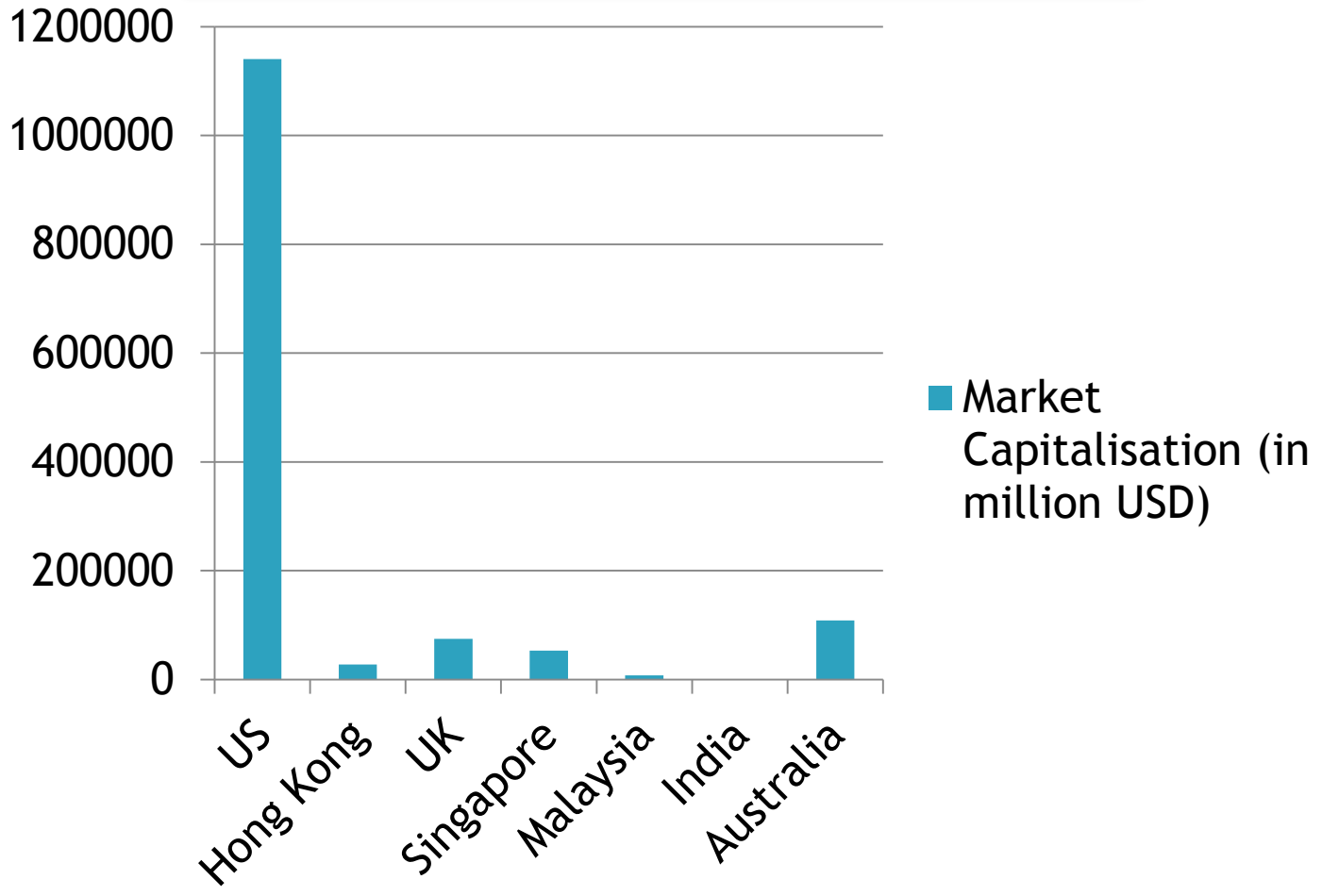


Source : https://www.sebi.gov.in/statistics/1392982252002.html

REITs and InvITs

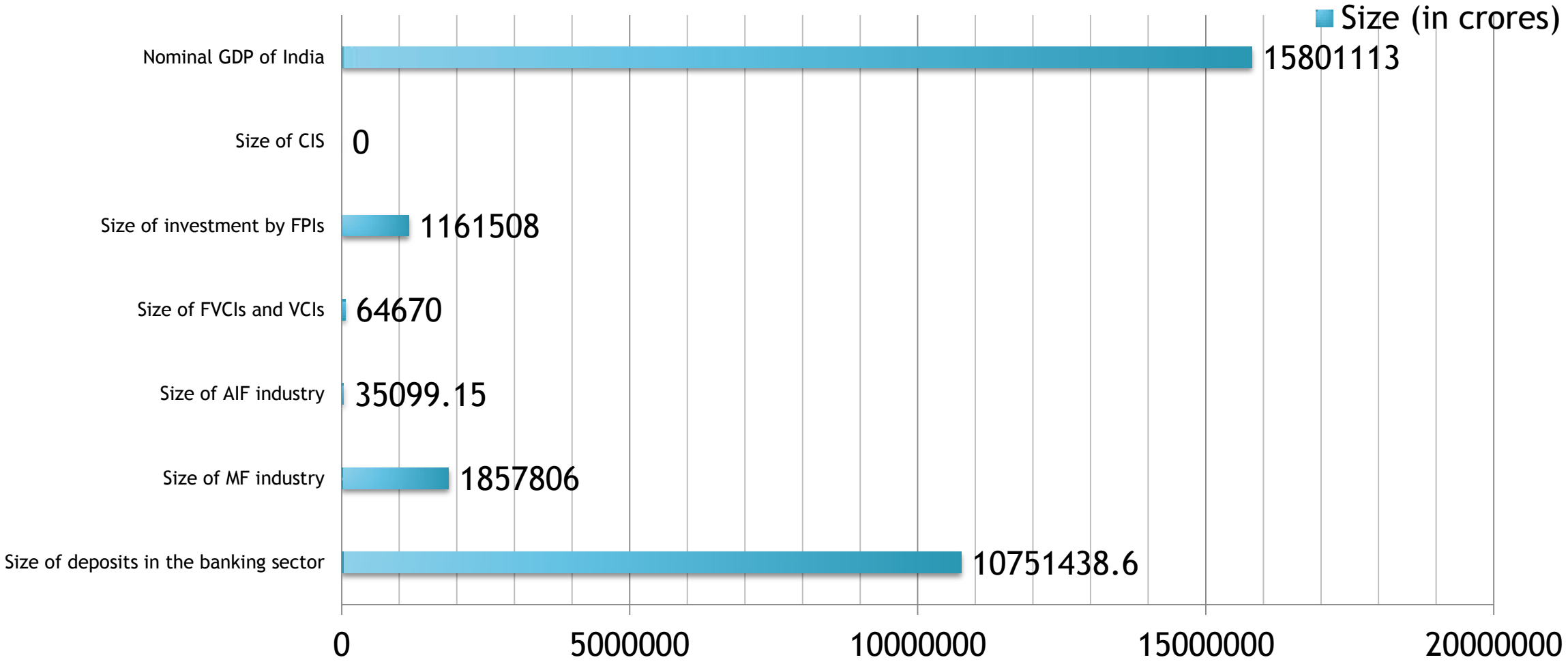
- As on 21st February, 2018, there are no registered REITs;
- In total, 6 InvITs are registered:
  a. GMR Infrastructure Investment Trust;
  b. IL&FS Transportation Investment Trust;
  c. India Grid Trust;
  d. IRB InvIT Fund;
  e. MEP Infrastructure Investment Trust;
  f. Reliance Infrastructure InvIT Fund.
- The first InvIT was IRB InvIT Fund, registered on 14th March, 2016;
- IRB and IndiGrid had been trading at a price below their issue prices:
  - IRB InvIt at approx 16% discount on issue price
  - IndiGrid at about 8% discount

Market Capitalisation of REITs in the international market (in million USD)



Source: EPRA Global REIT Survey 2017

Size of different CIVs vs. GDP (as on 31st March, 2017)



Source: Compiled by author from various sources

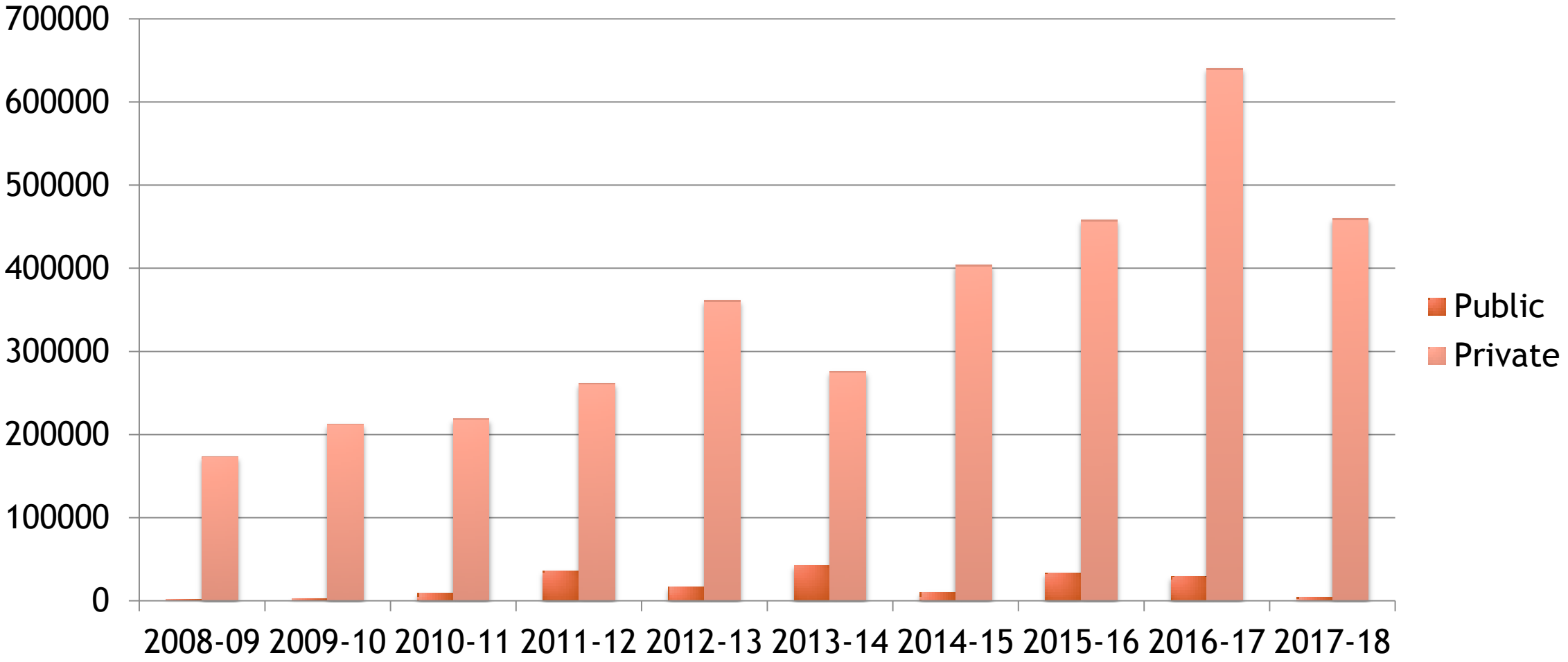
Instruments allowing borrowers to access capital markets for debt funding

Types of instruments

- Debt securities
  - Secured debentures
  - Unsecured debentures
  - Structured debentures
- Securitised debt instruments
- Commercial paper
- Secondary market in loans – securitisation and Mortgage-backed securities
- P2P lending platform

Popularity of bond market in India

Aggregate issue of Corporate Bonds



Aggregate corporate balance sheet: *funding by different sources*

Sources of funds for the corporate sector (pvt. ltd. companies) (Rs. in Million)

Particulars	During FY 2013-14	During FY 2014-15	During FY 2015-16
Share capital	2417478	2769678	3012709
Money received against share warrants	5203	4844	5314
Bonds and debentures	**531382**	**706839**	**841123**
Term loans from banks	2118260	2360468	2535581
Secured term loan	1925593	2153916	2331017
Deposits	53155	41518	52975
Loan and advances from related parties	783580	763839	817607
Long-term maturities of financial lease obligation	6105	9078	13368
Other long-term liabilities	400217	562140	593498
Short-term Loans repayable on demand (from banks)	1136296	1468883	1552016
Short-term loans and advances from related parties	237932	508443	683870
Short-term deposits	18285	54456	38354
Other short-term loans and advances	1675779	1232392	1255925
Aggregate size of the balance sheet	**22976747**	**25804210**	**27963508**

Source: Database on Indian Economy, Reserve Bank of India

Sources of funds for the corporate sector (public ltd. companies) (Rs. in Million)

Particulars	During FY 2013-14	During FY 2014-15	During FY 2015-16
Share capital	2720051	3152698	3364419
Money received against share warrants	9064	13752	17301
Bonds and debentures	**914717**	**1216761**	**1410105**
Term loans from banks	4384301	4662451	4535176
Secured term loan	3440065	3698086	3600592
Deposits	58353	47265	71139
Loan and advances from related parties	470952	555249	566829
Long-term maturities of financial lease obligation	9305	4544	4796
Other long-term liabilities	548072	583447	655075
Short-term Loans repayable on demand (from banks)	1932745	1821211	2107173
Short-term loans and advances from related parties	128386	379629	379064
Short-term deposits	38707	49734	54530
Other short-term loans and advances	1747985	1535991	1434694
Aggregate size of the balance sheet	**36425875**	**39460062**	**42799906**

Source: Database on Indian Economy, Reserve Bank of India

Percentage share of bonds (comparison)

	During FY 2013-14	During FY 2014-15	During FY 2015-16
% share out of total bal. sheet size (pvt. Ltd. companies)	**2.31%**	**2.74%**	**3.00%**
% share out of total bal. sheet size (public limited companies)	**2.51%**	**3.08%**	**3.30%**
% share out of total bal. sheet size (non-govt. non-banking financial and investment companies)	**16.50%**	**11.51%**	**10%**

Investment by MFs into bonds

- A MF may subscribe to bonds issued by companies subject to the concentration norms specified by SEBI in this behalf.
- SEBI has detailed out the **prudential limits in sector exposure and group exposure in debt-oriented MF schemes**.
- The **overall limit** for sectoral exposure in debt-oriented funds has been fixed at **25%.**
- The exposure limit provided for **HFCs** in finance sector was reduced to 5% from 10% in circular dated 15th Feb, 2016. However, it was later on revised back to **10%** vide circular dated 10th August, 2016. It was further revised in on 22nd Feb, 2017 to **15%**.
- Limit on total exposure of debt schemes of mutual funds in a **group** (excluding investments in securities issued by PSUs, PFIs and PSBs) is fixed at **20%** of the net assets, which can be revised to **25%** with the prior approval of Board of Trustees.

Difference between MF, AIF, CIS and REITs and InvITs

Particulars	MF	AIF	CIS	REITs/ InvITs
Public/ private	Both	Private (Indian or Foreign)	Public	Public
Minimum size	Rs 20 crore per scheme	Rs 20 crores	Rs 100 crores	Rs 500 crores
Nature of investment	In capital market securities	In capital market and properties both, based on the scheme of the fund	In capital market and properties both, based on the scheme of the fund	REITs – income-earning real estate InvITs – operationalized projects
Listing	Closed-end, yes; open-end - No	Not compulsory	No	Compulsory
Open/ close-ended	Both	Cat I and II – close-ended Cat III – both	Open-ended	Both
Tenure	Fixed maturity as well continuing maturity	Cat I and II – min. 3 years Cat III – not fixed	May be fixed or open-ended maturity	Typically, open-ended maturity
Liquidity (exit opportunity)	Open-ended: Provided by fund; closed-end - market	Given by fund	Given by fund	Sold in open market
Tax transparency for the fund	Fund is tax transparent	Cat I and II – yes Cat III - no	No	Yes – to the extent of rentals, interest Capital gains: No
Taxability of investors	Dividend distribution tax in	In case of Cat I and II - yes	Yes	Income that did not suffer

Regulations applicable to different types of investment vehicles

AIF Regulations

Key features of an investment scheme

- Contributions made by investors are pooled
  - Key word is investors
  - Investors mean persons who are not managing their own money
- Utilized for the purpose of a scheme
- With a view to receive profits, income, property, whether movable or immovable
  - SEBI/courts in several cases have taken the view that mere sharing of the use of a property is not an investment scheme
    - Guaranteed returns is the feature of an investment scheme
- Managed on behalf of the investors
- Investors do not have day to day control

- AIF means
  - Any fund established in form of a trust, company or LLP
  - Is a privately pooled investment vehicle
  - Collecting funds from investors, Indian or foreign
  - For investing in accordance with
  - Defined investment policy
  - For the benefit of its investors

  AND
  - Is not a mutual
  - Or a CIS
  - Or any other regulated fund management

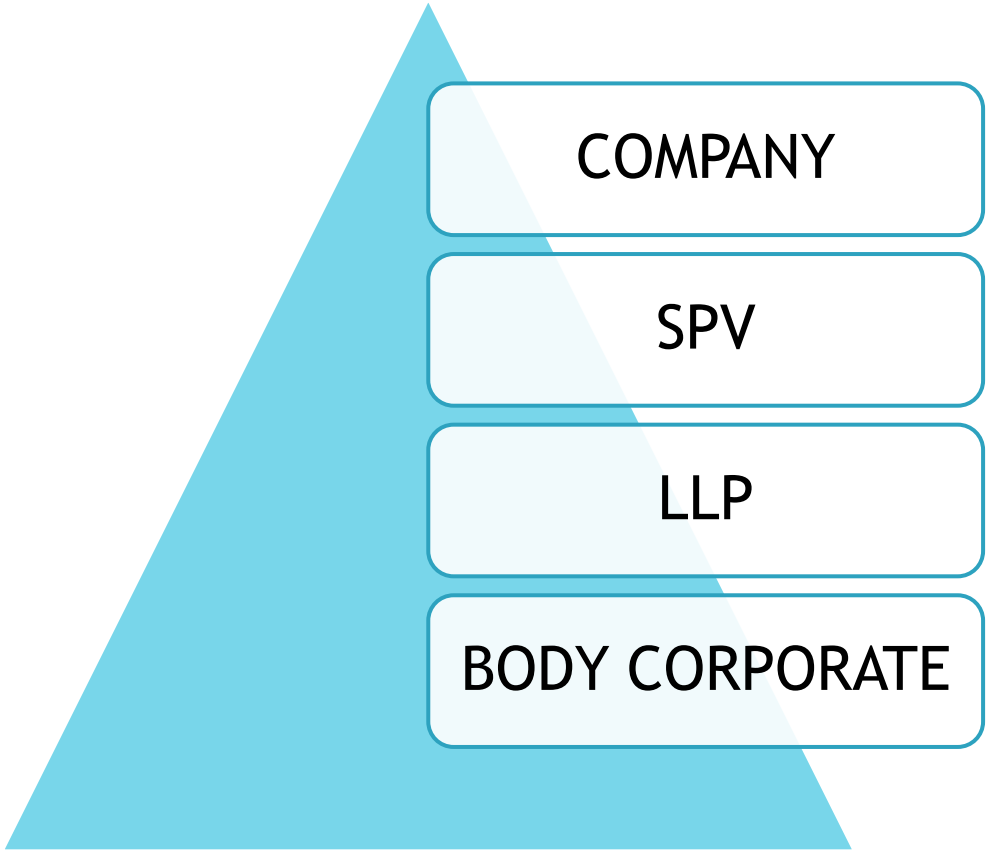
These are not AIFs

- family trusts set up for the benefit of relatives
- ESOP Trusts
- employee welfare trusts or gratuity trusts
- holding companies within the meaning of Section 4 of the Companies Act, 1956
- Other SPVs not established by Fund managers, securitization trust
- Funds managed by securitisation company or reconstruction company

Any such pool of funds which is directly regulated by any other regulator in India

What can an AIF do?

- Make investments in accordance with a scheme
  - In any legal entity
- Generally, AIFs do not hold real properties
- Can AIF grant loans?
  - SEBI FAQs no 7 of SEBI FAQs on AIFs says AIF cannot grant loan
  - However, SEBI ruling dated 29th Nov 2017 seems to suggest AIFs can grant loans

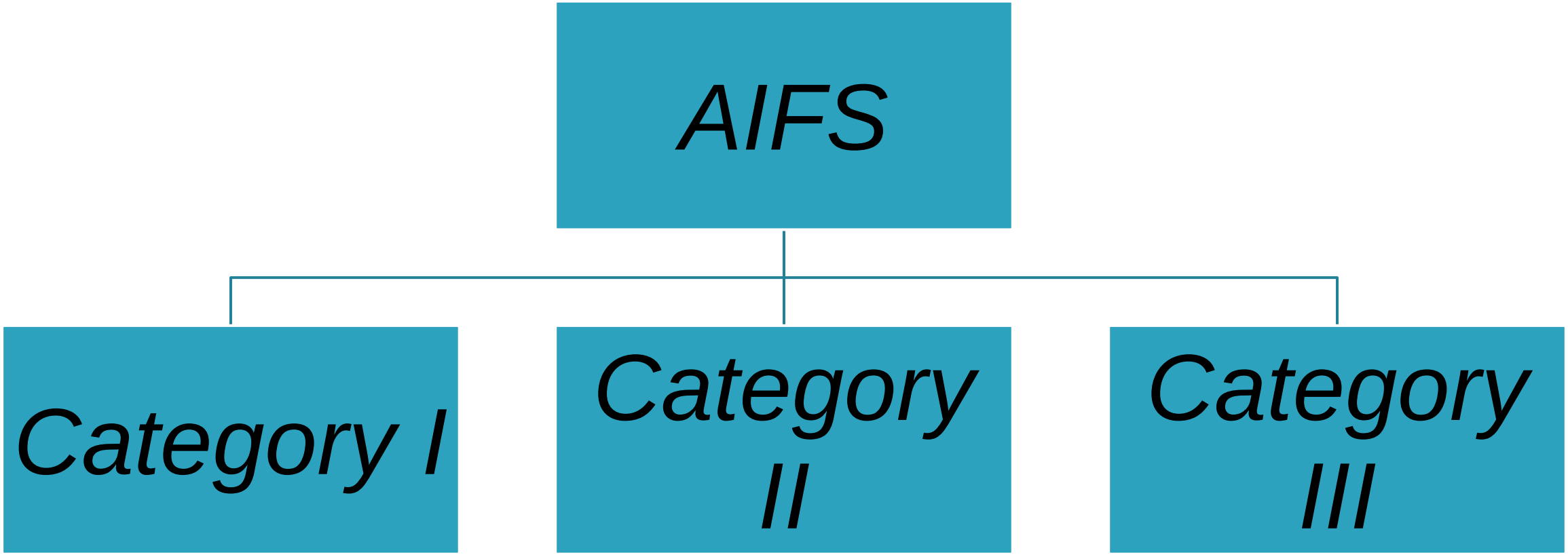


REGISTRATION

- No entity or person to act as an AIF, unless holding a certificate of registration from the Board:

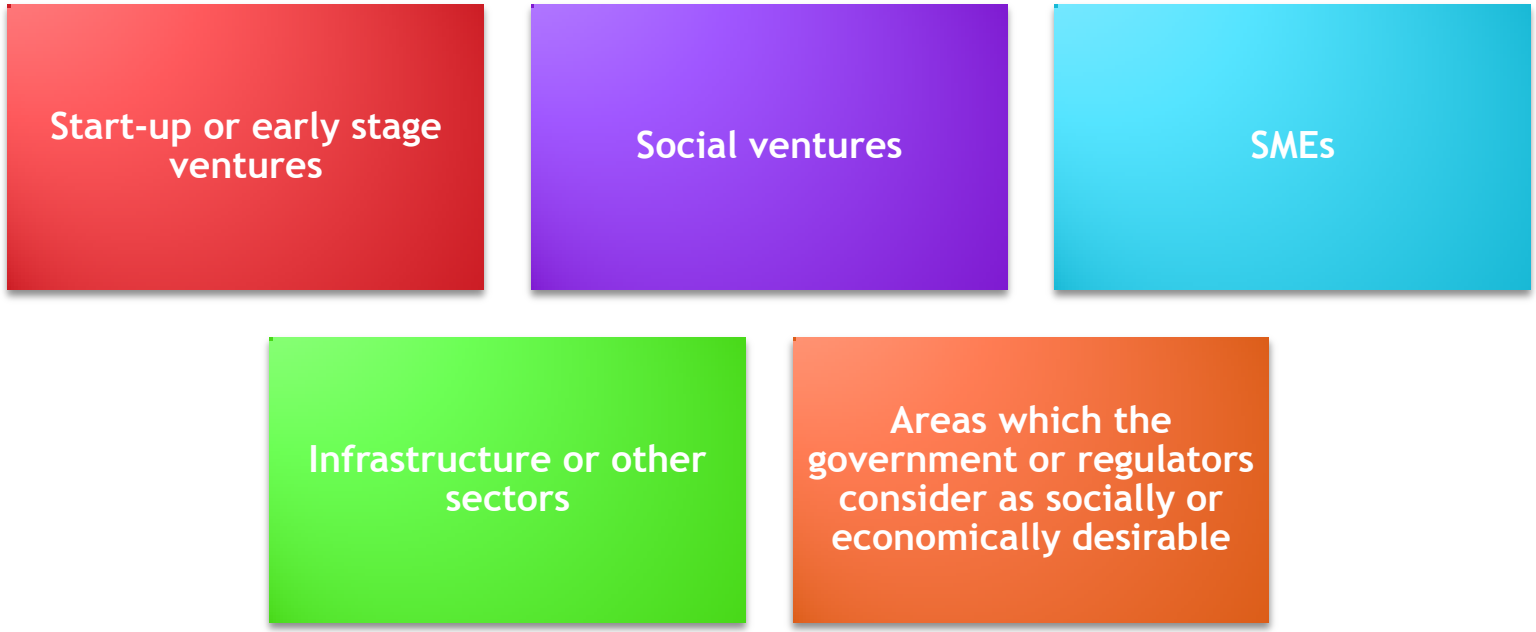
  For already existent fund not registered with SEBI-
  - May continue to operate for six months from commencement of Regulations or
  - till the disposal of application if the application is made within these six months.
  - Existing schemes can complete their agreed term and schemes however, restriction on raising fresh monies other than commitments already made.

CATEGORIES OF AIFs



Category I AIF

- This category of AIF will invest in:



Category II AIF

Does not fall in Category I or Category II

Does not undertake leverage or borrowing, other than to meet day-to-day obligations.

- Thus, mainly functions out of its own corpus

This category would also include PE funds or debt funds for which no special incentives or concessions are given by the Government.

Category III AIF

Thus, effectively in the nature of hedge funds already defined in Regulation 2

Can employ leverage

Employs diverse or complex trading strategies

also include hedge funds or funds with a view to make short term returns or open ended funds, which do not have any concessions or specific incentives by the government

Investment in AIF [regulation 10]

- **Issue of units allowed to any investor**
  - Indian,
  - Foreigner or
  - Non-Resident Indian (NRI)
  - Currently the FDI policy allows issue of units only to VCFs and FVCI. Therefore, seems that reciprocal change will be effected in FDI policy so as to bring them in line with the AIF Regulations and include AIFs

Conditions for an AIF

- Each scheme to have corpus of at least **Rs. 20 crore**
  - **Angel fund Rs 10 crores**
- Manager or sponsor to have **continuing interest** in the form of investment of **not less than:**
  - 2.50% of corpus
  - Rs. 5 crore, whichever is less
    - However, such interest shall not be through the waiver of management fees. Thus, manager or sponsor will be entitled to receive their fees and rightfully so.
- Maximum 1000 investors per scheme
  - However, the vehicle has to be privately pooled
    - So the number of 1000 is unreasonably large

RBI allows investment by FPIs in AIFs

- RBI has via notification introduced certain amendments in the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) (Eleventh Amendment) Regulations, 2015 for permitting investments by FPIs in the units of AIFs
- FPIs are now allowed to invest in Category III AIFs in terms of Regulation 21 (1) (n) of SEBI (FPI) Regulations, 2014
- An FPI shall not hold more than 25% stake in a Category III AIF

Placement Memorandum [Regulation 11]

- **Funds to be raised by issue of Information Memorandum/ Placement Memorandum ("IM/PM").**
- **IM to contain information, the key being:**
  - Material information about AIF and Manager
  - Background of key investment team of manager
  - Tenure of AIF or scheme
  - Targeted investors
  - Investment strategy
  - Risk management tools and parameters employed
  - Conflict of interest and procedures to identify and address them
  - Manner of winding up of the Alternative Investment Fund or the scheme
    - The points so covered in the AIF Regulations are only inclusive in nature. AIFs to share other relevant information as required to help investors take an informed decision.
    - The procedure contemplated here, is similar to that of public offering of equity shares.

Schemes [Regulation 12]

- AIFs may launch schemes subject to filing of PM.

- PM to be filed with SEBI atleast 30 days before the launch of the scheme along with the fees prescribed in Second Schedule
  - Scheme Fees is Rs. 1 lakh
  - Payment of scheme fees not applicable for launch of first scheme

Tenure [Regulation 13]

Category I and Category II

- Close ended
- Tenure to be pre-defined, subject to minimum of three years

Category III

- Open ended or close ended

Extension

- Extension of close ended AIF permitted upto 2 years
  - Approval of 2/3rds (66.67%) of unit holders required

- In the absence of consent of unit holders, AIF to fully liquidate within one year following expiry of fund tenure or extended tenure.

Listing [Regulation 14]

- Units of close ended AIFs may be listed subject to minimum tradable lot of Rs. 1 crore
  - Slightly unclear
  - Does it mean that the close ended AIFs **may or may not** go for listing?
    - Therefore, open ended AIFs **may** go for buy back

- Listing permitted only after final close of the fund or scheme

General investment conditions

Companies outside India

- AIFs may invest in securities of companies incorporated outside India subject to such conditions

Category I, II and III

- Category I and II to not invest more than 25% of corpus in one investee company
- Category III to invest not more than 10% of corpus in one investee company

Uninvested portion?

- Un-invested portion of the corpus may be invested in liquid mutual funds or bank deposits or other liquid assets of higher quality till deployment of funds as per the investment objective.
  - Thus, AIFs can invest funds according to their investment objectives states in IM. In case of the un-invested portion, may be invested in liquid assets

Investment barred without consent of 75% of investors by value of their investment in AIFs

Investment conditions for category 1 [regulation 16]

- Shall invest in VCU or SPV or LLPs or other units of AIFs
- May invest in units of Category I AIFs of same sub-category
- **Shall not** borrow funds or engage in any leverage except:
  - **For meeting temporary funding requirements:**
    - **Not more than 30 days**
    - **Not more than 4 occasions in a year**
    - **Not more than 10% of corpus**
- **Therefore, Category I can fund in another fund too**

Category I-sectoral caps [regulation 16]

VCFS

- **Additional conditions for VCFs- same as VCF Regulations**
  - two-thirds/66.67% of the corpus shall be invested in unlisted equity shares or equity linked instruments
- **Not more than 1/3rd of corpus in:**
  - IPO of VCU
  - Debt or dent instrument in which investment already made by way of equity or contribution towards partnership interests
  - Preferential allotment of equity shares of listed company- lock in period of 1 year
  - Equity shares of a listed financially weak company or sick industrial company
  - SPV

Contd….

SMEs

- Invest atleast 75% of corpus in unlisted securities or partnerships of VCUs or listed or proposed to be listed SMEs
- Such funds may enter into an agreement with Merchant Banker to subscribe to unsubscribed portion of issue
- Such funds exempt from Regulations 3 and 3A of Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992 in case of investment in companies listed on SME exchange subject to conditions prescribed.

Contd….

Social Venture Funds

Atleast 75% of corpus in unlisted securities or partnership interest of social ventures	May accept grants, subject to limit provided above	may give grants to social ventures, subject to disclosure in IM	may accept muted returns for their investors

Contd….

INFRASTRUCTURE FUNDS

Atleast 75% of corpus in

- unlisted securities or partnership interest of venture capital undertaking or SPVs
- involved in *operating, developing or holding infrastructure projects*

may also invest in

- listed securitized debt instruments or listed debt securities of investee companies or SPVs
- involved in *operating, developing or holding infrastructure projects*

Category II-sectoral caps [regulation 17]

Shall not borrow funds, or engage in any leverage except-
For meeting temporary fund requirements
For not more than 30 days, not more than 4 occasions in a year, not more than 10% of the corpus

Invest primarily in unlisted investee companies or in units of other AIFs

May invest in Category I or II AIFs

Barred from investing in units of other FoFs

May engage in hedging, subject to guidelines specified by SEBI

May enter into an agreement with Merchant Banker to subscribe to unsubscribed portion of issue

Exempt from Regulations 3 and 3A from Insider Trading Regulations in case of investment in companies listed on SME exchange subject to conditions prescribed.

Category III-sectoral caps [regulation 18]

May invest in securities of listed or unlisted investee companies or derivatives or complex or structured products
May invest in units of Category I or II AIFs **Barred from investing in units of other FoFs**
May engage in leverage or borrow subject to consent from the investors in the fund and subject to a maximum limit, as specified by SEBI. **Such funds to make disclosures as specified**
To be regulated through issuance of directions on operational standards, conduct of business rules, prudential requirements, restrictions on redemption and conflict of interest as may be specified by SEBI.

General Obligations and conflict of interest

Regulation 20

- Sponsor or manager to appoint custodian for safe keeping of securities if corpus more than Rs. 500 crore
  - For Category III, custodian to be appointed irrespective of size of corpus
- In case of change in control, prior approval of SEBI required

Regulation 21

- Sponsor and manager to act in fiduciary position
- Manager to establish written policies for mitigating conflict of interest

Transparency [Regulation 22]

- All AIFs to ensure transparency and disclose information to investors relating to inter alia:
  - risk management,
  - any fees ascribed to manager or sponsor,
  - any material liability,
  - any enquiries by legal or regulatory bodies
- AIFs to provide on annual basis, within 180 days from year end:
  - Financial information of investee companies, material risks and management of the same.
- Category III AIFs to submit quarterly reports within 60 days of end of quarter on the basis of points givne above

Valuation [Regulation 23]

- Category I and II AIFs to undertake valuation of their investments atleast once
  - in every 6 months
  - by an independent valuer
    - May be enhanced to one year on approval of 75% of investors
- Category III AIFs to ensure calculation of NAV Category is
  - independent from the fund management function.
  - NAV to be also disclosed at intervals provided

Winding up [Regulation 29]

- Methods of winding up by trusts, LLP, company, body corporate provided separately for each
- Trustee or trustee company or BoD or designated partners of AIFs to intimate SEBI about the circumstances leading to winding up
- No investments to be made after such intimation
- Within one year of intimation, assets to be liquidated and proceeds to be distributed to investors after satisfying all liabilities
  - Same treatment as of equity investors in a company

Regulations applicable on CIS in India

Collective Investment Schemes (CIS): Meaning

- Scheme or arrangement made or offered by any company
  - under which the contributions, or payments made by the investors are pooled and utilised with a view to receive profits, income, produce or property
  - is managed on behalf of the investors.
- Investors do not have day to day control over the management and operation of such scheme or arrangement.

Schemes not treated as CIS

- scheme or arrangement made or offered by a co-operative society;
- scheme or arrangement under which deposits are accepted by NBFCs;
- scheme or arrangement being a contract of insurance to which the Insurance Act, applies;
- scheme or arrangement providing for any Scheme, Pension Scheme or the Insurance Scheme framed under the Employees Provident Fund and Miscellaneous Provisions Act, 1952
- scheme or arrangement under which deposits are accepted under section 58A of the Companies Act, 1956;
- scheme or arrangement under which deposits are accepted by a company declared as a Nidhi or a mutual benefit society under section 620A of the Companies Act, 1956;
- scheme or arrangement falling within the meaning of Chit business as defined in section 2(d)of the Chit Fund Act, 1982;
- scheme or arrangement under which contributions made are in the nature of subscription to a mutual fund;

Eligibility Conditions

- applicant is set up and registered as a company under the Companies Act, 1956
- applicant has a net worth of not less than Rs. 5 crores
- managing of collective investment scheme as one of its main objects is states in its MoA
- Atleast 50% directors shall be independent
- CIS company is not the trustee of any CIS

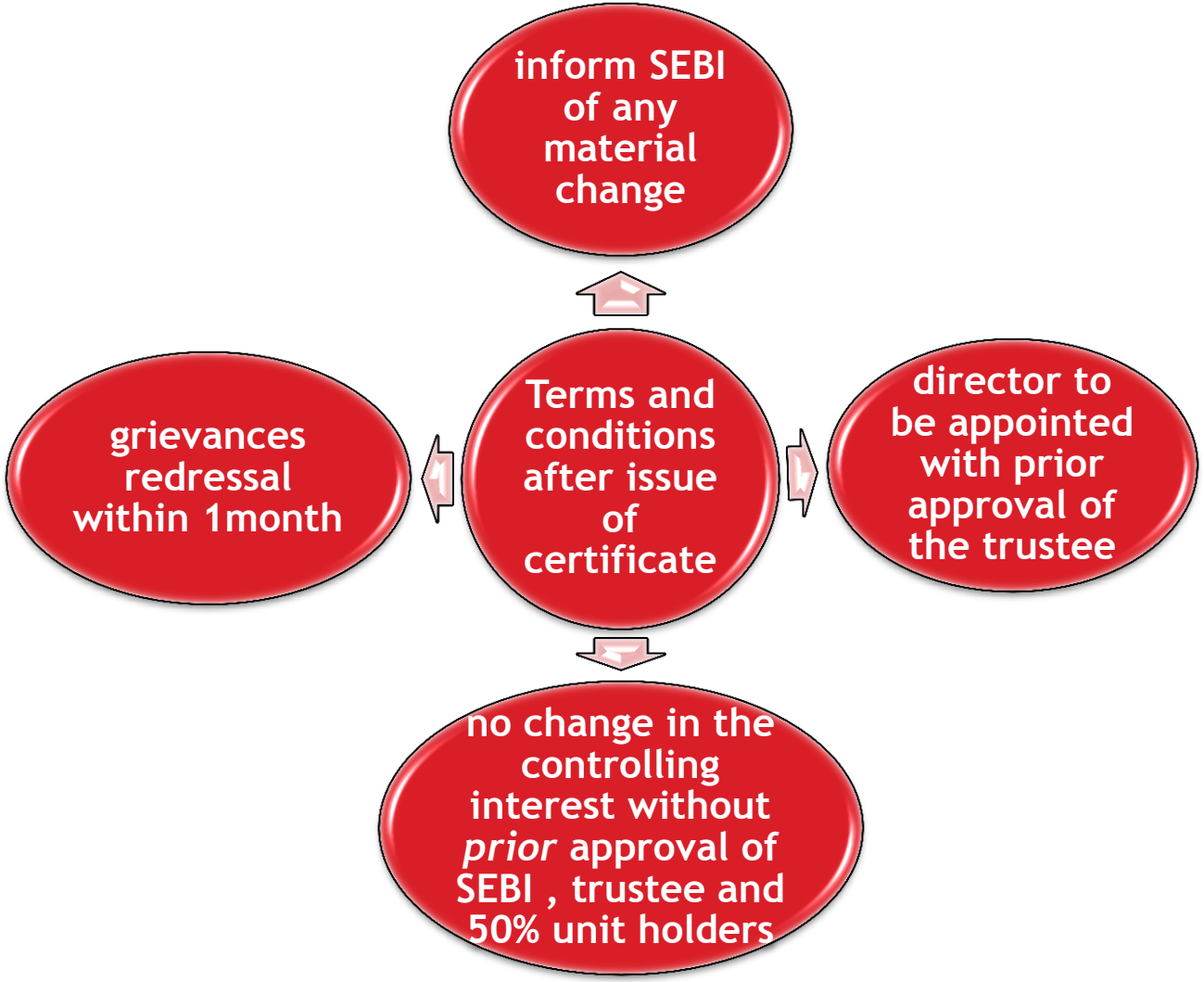
Obligations before the launch of any scheme

- Scheme to be approved by trustee
  - Registered as debenture trustee are eligible to be appointed as trustees
- Appraisal by an appraisal agency *and* credit rating by any such agency.
- Duration of schemes shall not be less than 3 days
- No scheme shall provide guaranteed or assured returns
- Scheme to be open for not more than 90 days
- All unit certificates to be freely transferable
- Listing of schemes allowed, if mentioned in the offer document

Disclosures

- An annual report and annual statement of accounts to be prepared in respect of each financial year
- within two months from the date of closure of each financial year forward to SEBI a copy of the Annual Report
- Publish unaudited results within 1 month of end of each quarter in newspapers

SEBI CIS Regulations contd..



SEBI CIS Regulations

Restrictions on business activities

- undertake any activity other than that of managing the scheme
- act as a trustee of any scheme
- launch any scheme for the purpose of investing in securities
- invest in any schemes floated by it

Obligations of CIS company

- be incompetent to enter into any transaction with or through its associates or relatives relating to the scheme
- give receipts for all monies received by it and give a report to SEBI every month, particularly of receipts and payments
- hold a meeting of its BoD at least *twice* in every three months
- obtain adequate insurance against the property of the scheme

Registered CIS

- Only one CIS, M/s.Gift Collective Investment Management Company Limited;
- Registered during 2008-09;
- No CIC launched as on 31.03.2017.

Regulations applicable on REITs in India

REIT regulations in India

- SEBI (REIT) Regulations 2014
  - May be said to be enabling as well as regulatory instrument
- Statutory powers only under the SEBI Act
  - The power under sec 11 of the Act nearest to a REIT is a collective investment scheme
  - It seems logical to say that a REIT must be a CIS in order for it to face the regulatory restraint of the REIT
- Regulations contain a bar on anyone carrying a REIT activity without registration with SEBI
- REIT Regulations may be said to be laying the complete law on REITs in India
  - Taxation provisions refer to SEBI REIT regulations

Highlights of REIT regulations in India

- Regulations permits only properties in India
  - Many countries permit geographical diversification
- Unlike US regulations, India does not permit mortgage assets at all
  - US regulations permit REITs to be either equity, or mortgage, or hybrid
- Leverage restrictions
  - 49% of the value of REIT assets [reduced from 50% as proposed in the draft Regulations], with a requirement to seek credit rating if leverage exceeds 25% of REIT assets
- SPV properties
  - As a unique feature, Indian regulations permit holding of properties through SPVs, where the REIT has controlling interest
- Closed-end, listed
  - REITs in India will be closed-end, listed trusts
- Minimum size
  - REITs to have a minimum asset value of Rs 500 crores [reduced from Rs 1000 crores as proposed in the draft Regulations]

Highlights of REITs regulations

- Public offer is mandatory
  - Initial capital will be raised mandatorily by public offer [Reg 14 (1)]
  - Subsequent offers may be made by way of follow-on public offer, preferential allotment, institutional placement, rights issue, bonus issue, offer for sale etc
  - Minimum public holding 25%
- Minimum offer size: Rs 250 crores
- Investment size
  - No significant investment size restrictions; trading lot Rs 1 lac
- Minimum number of investors
  - Public unit holders at least 200 at all times

Meaning of a REIT

- There is no definition of "REIT" in the Regulations.
  - Para 2 (1) (m) defines a REIT as a Real Estate Investment Trust; there is no definition or meaning assigned to the term "real estate investment trust"
    - Hence, the definition reaches a dead-end
- However, in view of the scheme of the SEBI Act and the Regulations, a REIT must have the following features
  - It is not a real-estate owning company (REOC)
  - It is not a real estate owning LLP or partnership
  - It is a trust; pooling investments
    - It is a collective investment device
  - It is not a joint-venture, co-ownership or any other vehicle where there is no distancing between ownership and management
  - It issues "units" to raise financing
    - Units are defined to mean beneficial interest

Meaning of a REIT -2

- REIT needs to satisfy two major criteria
  - Asset criteria
  - Income criteria
- Asset criteria
  - At least 80% of the investments to be in rent generating properties, including investment in Holdcos and SPVs
- Income criteria
  - At least 75% of the income, other than capital gains, to be from rentals
- In sync with global regulations, REITs in India are also required to ensure minimum distribution
  - Minimum 90% of the net distributable cash flows will be distributed to unitholders on a half yearly basis

Meaning of a REIT -3

- Exposure on Project
  - The REIT shall have to invest in atleast 2 projects (now amended to allow investment in single project);
  - The investments shall be in accordance with the provisions stipulated in regulation;
  - However, maximum exposure to a single project has been restricted to 60% of the value of the assets.
- Unit holders
  - REIT will have only one class of units
    - However, since underlying the REIT is an SPV, the SPV may have different classes of securities
- Schemes
  - No schemes to be launched under a REIT
  - So a REIT is one pool of assets

Exposure on Project

- Previously REITs were required to hold atleast two assets with maximum 60% invested in a single asset
  - Now this provision has been done away with.
  - REITs can now hold a single asset
- The previous provision also stated that such 2 assets should cumulatively be worth of atleast Rs. 500 crore
- So now that single asset held by the REIT should meet such quantitative requirement
- The proposal of permitting a single asset should enable owners of large value assets to explore REITs

Assets that a REIT may hold

- Reg 2 (1) (o) defines “REIT assets” as real estate assets or “other assets” held directly or through a special purpose vehicle
- “Real estate assets” are defined in reg 2 (1) (n) to “properties” held by a REIT either directly or through an SPV
- “properties” or real estate” are defined in reg 2 (1) (l)
  - to include buildings, sheds, garages, fences, fittings, fixtures, warehouses, carparks or other assets incidental to real estate
  - Excluding
    - Mortgages
      - Exclusion seems to be mortgage asset, and not mortgage liability
    - TDRs – conditionally allowed
    - Infrastructure assets

Assets that a REIT may hold -2

- However, the primary limitation on REIT assets comes from Reg 18 (4)
  - At least 80% of REIT assets [reduced from 90% as per draft Regulations] shall be in "completed, rent generating properties"
  - Upto 20% REIT assets may be in other eligible assets
    - Development properties
      - With the condition that the property has to be at least 3 years after completion, and must be leased out
    - Listed or unlisted debt of companies
    - MBS
    - Listed equities of companies, which derive at least 75% income from real estate activity
    - Government securities
    - Money market instruments or cash equivalents
- Thus, the "other assets" referred to in Reg 2 (1) (o) are limited to 20% of total REIT assets
- 80% of the assets have to be rental properties

Properties that a REIT may hold

- Rented residential properties
- Rented commercial properties
  - Office properties
  - Shopping properties
  - Hospitals
  - Hotel properties
  - Godowns/warehouses
  - Factory properties
  - Other similar properties
- Renting requirement
  - At least 75% of the area must have been rented/leased out [exp below Reg 18 (4)]

Properties that a REIT cannot hold

- Mortgage assets, that is, mortgage loans
  - Bar in reg 2 (1) (l) and in reg 18 (2) seems to be on mortgage assets; does not prohibit the REIT acquiring or holding mortgaged properties
- Transferable development rights
  - Except where acquired for the project where REIT has already made investment [reg 18 (5) (g)]
- Properties or securities out of India
- Vacant land or agricultural land
  - The term “agricultural land” has been interpreted in several rulings under SARFAESI Act
  - Carve out in case of land which is contiguous, or extension of a project being implemented in phases
- Units of other REITs

Holding of properties through SPVs

- Unique feature of Indian regulation- clearly for avoiding stamp duties on transfer of properties from the present owner to the trust
- SPV - defined in reg 2 (1) (p) to body corporate in which a REIT holds/proposes to hold controlling interest
  - "Controlling interest" is coming clear from Reg 18 (3) (b) to mean not less than 51% of equity capital of the SPV
- As the SPV can be only body corporate
  - It may be a company
  - It may be an LLP
  - Since cooperative societies are not "bodies corporate" as per Companies Act, by virtue of reg. 2 (2), Companies Act definition will apply to the Regs.
- Manner of REIT making investment in SPVs
  - Equity
  - Debt
  - Equity linked instruments
  - Partnership interest

Holding properties through SPVs -2

- Reg 18 (3) places essential restrictions regarding holding of properties through SPVs
  - SPV must hold properties directly and not through other SPVs
    - At least 80% [reduced from 90% as proposed in the draft Regulations] investment in properties
  - REIT must hold at least 51% controlling interest
    - No apparent restriction on issue/holding of preference capital
  - No shareholder must have any right to prevent the SPV from ensuring compliance with the provisions of the Regulations
    - Does this mean the SPV will also be subject to minimum dividend distribution requirement? Answer should be yes
    - May require stipulation in the articles of association of the SPV
  - At lease one representative on the board of the SPV nominated by the Manager, in consultation with the trustee

Holding properties through SPV -3

- Is the SPV subject to the same restrictions are the REIT?
  - Definition of “REIT assets” in reg 2 (1) (o) includes SPV assets too
  - Hence, the income/asset criteria should be applicable to REIT on a consolidated basis
- Are the dividend distribution requirements applicable to SPV too?
  - Seems logical; if SPVs are allowed to retain profits, the whole purpose of dividend distribution mandate gets frustrated
- Is SPV subject to leverage restriction?
  - Reg 20 (1) refers to “consolidated borrowings”
    - Obviously the borrowings of the SPV need to be added together
  - However, free hand for preference capital
  - Borrowings are a proportion of REIT assets
    - Hence, preference capital may be used for leveraging power too

Allowing REITs to lend to underlying Holdco/SPV

- As per the extant regulations, REITs were not allowed to lend funds. They could make investments only through debt securities.
- But with SEBI's amendments it is now possible for a REIT to lend to its Holdco/SPV.
- Earlier the REITs were not allowed to extend debt to the SPVs and since the SPVs are mostly in the nature of companies, the upward flow of funds from the SPV to the REIT suffered double taxation.
- This change would allow the REITs to extend debt to downstream SPVs which in turn can claim interest paid on such debt as expense.

Co-investment in properties

- A REIT may be a joint investor in properties
- Reg 18 (11) puts conditions for co-investment
  - Terms should not be more favourable to the other person
  - No rights with the co-investor which prevent the REIT from carrying obligations under the Regs
  - Co-investment agreement to provide for minimum distributions; pro-rata share of distributions; dispute resolution mechanism

Investment by REIT in developmental properties

- Regulation 18(5) provides for the 80:20 rule
  - 80% in completed, income earning properties
  - 20% in everything else
- The permissible limit for investing in properties other than that of completed and rent generating properties is a part of the 20%[enhanced from 10% as proposed in the draft Regulations] of the total value of REIT assets
- However, SEBI has provided a cap of 10% in the developmental properties alone.
- Thus, exposure of REIT in properties which are under construction phase has been restricted to 10%.

Investment restrictions

- Reg 18 is one of the most important regulations, setting investment regulations for the REIT
- 80:20 rule – 80% of the value of REIT assets to be in completed rent generating properties
- Within the 20% cap, a REIT may hold only eligible asses listed in Reg 18 (5)
- Sub-cap of 10% for properties under construction, or where construction complete, but not rent generating
- At least 75% of the revenues, other than capital gains, to come from rentals or income incidental to letting
- To hold at least 2 project
  - The word "project" is not defined; should properly mean a single property or complex
- Not more than 60% of total asset value in one project
- Investment conditions to be monitored on half yearly basis
- Minimum 3 year holding period
- For any sale of property or SPV shares exceeding 10%, untholders' approval is required

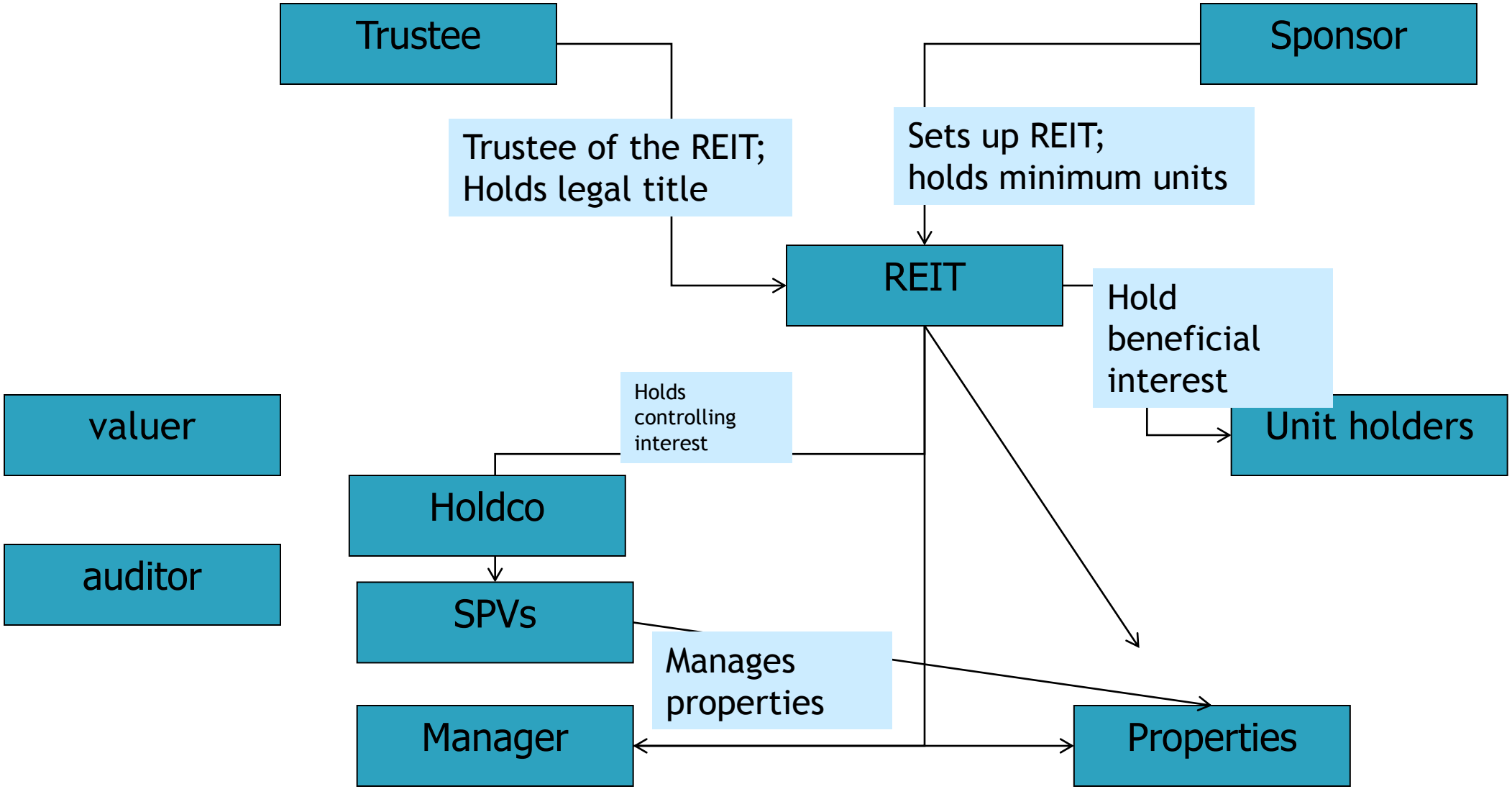
Leverage restrictions

- Restrictions applicable on a consolidated basis, and applicable to borrowings as well as "deferred payments"
  - Note, preference shares issued by the SPV not regarded as borrowings
  - Security deposits paid by tenants to regarded as borrowings
- Borrowings limited to 49% of the value of REIT assets
  - As borrowings exceed 25% of REIT assets, will require
    - Credit rating
    - Unitholders' approval
- Deviations due to market movements to be corrected within 6 months

Parties to a REIT

- “Parties to a REIT” [reg 2 (1) (c)
  - Sponsor (or redesignated sponsor)
  - Holdco
  - SPVs
  - Trustee
  - Manager
  - Valuer
- Other parties
  - Auditor
  - Registrar and Transfer agent
  - Merchant banker
  - Custodian
  - Lease managers appointed by the manager – Reg 10 (6)
  - Project manager in case of development properties – reg 10 (8)

Structure of REITs in India



Sponsor

- Sponsor is the entity that puts up the entire show and holds at least 25% of the unit at inception, and 15% throughout
- Regulations permit upto 3 sponsors
  - Each must be holding at least 5% of the units; collectively at least 15%
- Minimum Net worth of sponsor Rs 20 crores for each sponsor; Rs 100 crores put together
  - Whether net worth condition applicable to each sponsor, or all put together?
- At least 5 years experience in real estate industry on individual basis
  - Developer must have completed at least 2 projects
- Minimum investment in REIT
  - Exceeding 25% upto 1 year from listing
  - 25% upto 3 years from listing
  - 15% all through

Re-designated sponsor

- Where the sponsor wants to exit
  - Only after 3 years from listing
  - After obtaining sanction of unitholders as per Reg 22 (11)
  - Providing them exit option

Sponsor responsibilities

- Regulation 11 deals with the rights and responsibilities of the sponsor;
- It shall be the responsibility of the sponsor to set up the REIT in accordance with the provision;
- The appointment of Trustee shall be done by the sponsor;
- It shall adhere to requirement of maintaining specified percentage in the REIT as discussed earlier.

Trustee - eligibility

- Registered as Debenture Trustee
  - Debenture Trustee Regulations 1993 put a net worth requirement of Rs 2 crores
  - Must be a body corporate
- Not an associate of the manager, sponsor and principal valuer
- Not an investor in units of REIT [reg 9 (15)]
  - Should logically imply that trustee shall not hold shares of any SPV as well
- At least 50% of its directors are independent, and not “related parties” to the REIT

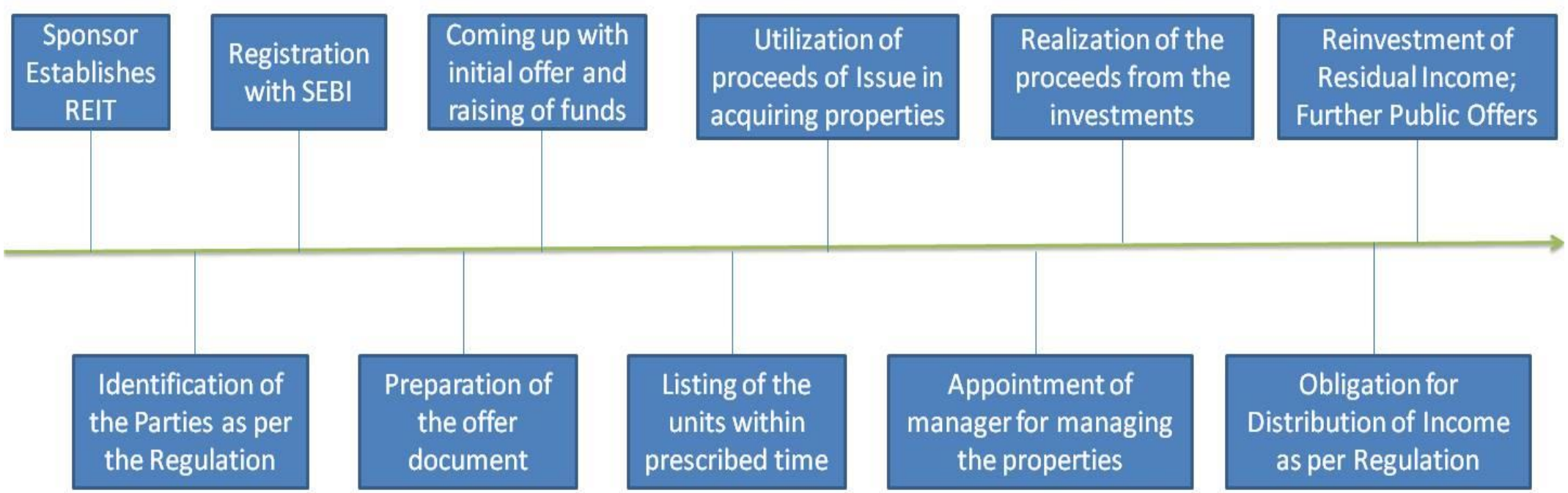
Manager - eligibility

- While trustee is the title holder of trust properties, Manager is the operating functionary of a REIT
- May be a body corporate or LLP
- Eligibility
  - Net worth of at least Rs 10 crores
  - At least 5 years experience in fund management/ advisory services/ property management or development of real estate
  - At least half of the directors/members of the governing board are independent
    - Not on the board/governing body of any other REIT

Valuer responsibilities

- Who can be valuer:
  - Registered valuer u/s 247 of the Cos Act
    - Until then, a chartered accountant with at least 10 years practice or a merchant banker
  - Should not be an associate of sponsor/manager/trustee
  - Should not be an investor in REIT units
  - There is also a restriction on sale of REIT units by valuer
    - Upto 6 months after ceasing to be a valuer
- Reg 21 (1) seems to be requiring mandatory rotation of valuer
  - However, it is seeming like putting a minimum number of years before rotation is done
  - No valuer to value a property for more than 4 years consecutively – reg 21 (9)
- Other responsibilities
  - The valuer shall discharge its duties in a true and a fair method taking into consideration the framework provided in Regulation 21, which deals with the valuation of asset

Life cycle of a REIT



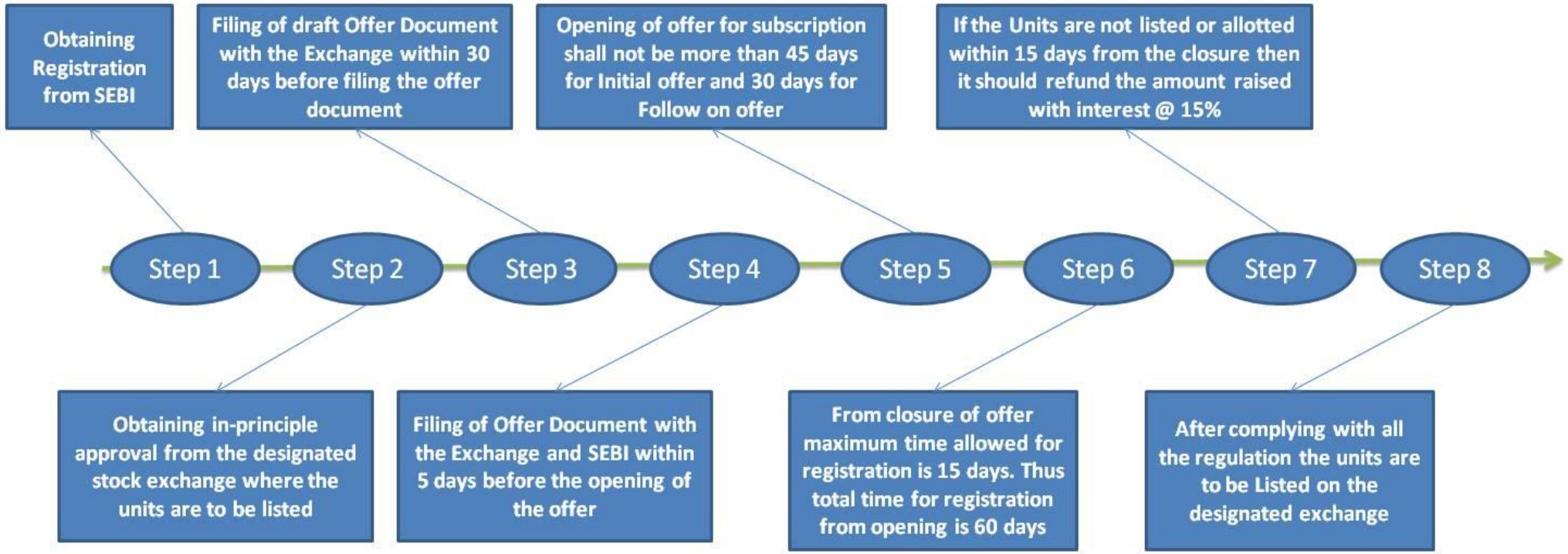
Fund raising 1/2

- The minimum value of REIT assets is Rs 500 crores
  - Minimum offer of Rs 250 crores; public offer 25% of the "value of the REIT"
  - "Value of REIT" [reg 2 (1) (dd)] is different from value of REIT assets
    - It refers to the NAV, net of the debt
  - Minimum offer requirement
    - Rs 250 crores – is that the public offer?
    - Public offer to be 25% of the NAV of the REIT
    - For instance, a REIT may have assets of Rs 500 crores, borrowings of Rs 250 crores, and make a public offer of 25% of Rs 250 crores?
  - Do "Offer size" and "public offer" mean the same?
    - Since more than 25% of the offered units have to be retained by the sponsor

Fund raising 2/2

- Some other aspects
  - Cases where refund is to be given to unit holders within 15 days from the closure of offer:
    - Where the subscription amount raised is less than 75% of the issue size;
    - Where the over subscription amount is more than the amount specified in the offer document;
    - The regulation also provides that maximum over subscription that can be retained cannot exceed more than 25% of the issue size;
    - Where the number of subscriber in the offer is less than 20. The number does not include related party of REIT
  - The REIT is supposed to allot the units or give refund within 10 days of the closure of issue. However, after the expiry of 15 days from closure, REIT shall be liable to pay interest to unit holders @ 15% till it makes refund or lists itself .

Procedural steps in a public offer



Mode of raising funding

- Previously REITs were allowed to issue only equity oriented securities
- On 18th September, 2017, SEBI vide a press release introduced an amendment allowing REITs and InvITs to raise debt capital by issuing debt securities
- The overall debt limit is set at 49% of its total value of assets
- Unit holders' approval not required to raise debt upto 25% of its total asset value

❖ *Any fund raising above this threshold limit shall require prior approval of the unit-holders and REIT will have to obtain a credit rating*

❑ REIT is expected to achieve 25% minimum public shareholding within 3 years of listing

Who can be investors in a REIT

- Trading lot is specified
- Reg 14 (12) says investment may be made by domestic or foreign investors
  - As regards foreign investors, investment as per FEMA rules
  - As per FEMA rules, FPIs are allowed to invest in listed securities
  - Budget speech did say NRIs may invest in REITs and IITs
  - As per SEBI circular dated March 15, 2016, RBI has made necessary amendments in Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) (Eleventh Amendment), Regulations, 2015 permitting investment by FPIs in the units of REITs

Valuation

- Reg 21 (1) seems to require mandatory rotation of valuer
  - No valuer to carry valuation more than 4 years [reg 21(9)]
- Full valuation to be done at least once in a year
  - Includes physical inspection of every property
  - Contents of full valuation report given in schedule V
  - Full valuation report to be a part of the annual report
  - To be submitted within 2 months from the end of the financial year
- Half yearly valuation be done by the valuer
  - Within 30 days from the end of the half year
- Full valuation also required prior to any initial public offer/ follow-on public offer
  - Report not more than 6 months old
- Valuation also required for every purchase /sale of properties
  - Sale/purchase prices not more than 10% plus/minus
- Also required where there is any material development affecting the valuation of REIT assets

Valuation Report 1/2

- Schedule V of the Regulation provides the contents of the valuation report. These are as follows:
  - Preliminary information such as name and brief detais of the valuer;
  - Description and explanations pertaining to methods adopted for valuation including assumptions used;
  - a declaration by the valuer that:
    - the valuer is competent to undertake the valuation;
    - the valuer is independent and has prepared the report on a fair and unbiased basis;
    - the valuer has valued the properties based on the valuation standards as specified under these Regulations;
  - any other matters which may affect the property or its value;

Valuation Report 2/2

- Property wise details of the following are to be provided:
  - Address of the property, ownership and title details including whether the transaction is a related party transaction;
  - a brief description of the property including age of the building, the site area, gross floor area, net lettable floor area etc;
  - the existing use of the property;
  - occupancy rate;
  - Date of inspection and date of valuation;
  - Valuation standards adopted for valuation of real estate assets;
  - Method used for valuation, qualifications and assumptions;
  - Holding interest of REIT in the said property;
  - Purchase price of the property by the REIT(for existing properties of the REIT)
  - Valuation of the property in the previous 3 years; (for existing properties of the REIT)

Rights of Unit Holders 1/3

- Regulation 22 provides the rights of the Unit holders. These are summarized as follows:
  - Trustee shall convene the annual meeting of all the unit holders once a year and the time gap between two meetings shall not exceed by 18 months;
  - The unit holders have a right to do the following:
    - Removal of existing auditor, manager and new appointments in the above place;
    - Removal of principal valuer and seek appointment of another principal valuer;
    - Requesting delisting of the REIT provided they have sufficient reason to believe that delisting is required;
    - Apply to SEBI for change in the trustee, provided they have adequate reason to believe that the acts of trustee are not beneficial to their interest;
    -

Rights of Unit Holders 2/3

- The unit holder have the rights to receive income as provided for in the offer document or in the follow on offer document;
- In the annual meeting of the unit holders following shall be taken into consideration (any other matter other than these can also be considered):
  - Placing of annual accounts of the REIT;
  - Approval of auditor and remuneration ;
  - Placing of latest valuation report;
  - Approval of valuer/principal valuer;
  - Any other matter
- Any matter which requires approval of unit holders shall be approved if passed by holders not less than 60% of the unit holders by value and by number;

Rights of Unit Holders 3/3

- In the following matters approval of atleast 75% of the value and by number shall be required:
  - Related party transactions requiring approval of unit holders;
  - Any transaction value of which is greater than or equal to 15% of the assets of the REIT;
  - Borrowings exceeding 25% of the value of the REIT assets;
  - Any change in investment strategy of the REIT;
  - Cases where the value of the units held by a person along with its associates other than the sponsor and its associates exceed 50% of the value of outstanding REIT units, approval is required for acquiring any further units;
  - Any issue which in the opinion of the sponsor or the manager requires approval of the unit holders;
  - Any issue, which in the opinion of the trustee, is material and requires approval of the unit holders

Strategic Investor

- SEBI (Real Estate Investment Trusts) Regulations, 2014 ("REIT Regulations")vide amendment notification dated December 15, 2017, inter-alia, define strategic investors under Regulation 2(1)(ztb) of the REIT Regulations and allows them to participate in REITs
- An InvIT/REIT if chooses to invite subscriptions from strategic investor will have to undertake the following manner:
  - The strategic investor shall either jointly or severally invite not less than 5% and not more than 25% of the total offer size
  - The investment manager or manager on behalf of the REIT shall enter into a binding unit subscription agreement with the strategic investor
  - The price at which the strategic investor has/have agreed to buy the units should not be less than the issue price determined in the public

Strategic Investor

- **'Strategic investor'** has been defined in Regulation 2 sub regulation 1 clause (zza) which means:
- an infrastructure finance company registered with Reserve Bank of India as a Non-Banking Financial Company;
- a Scheduled Commercial Bank;
- an international multilateral financial institution;
- a systemically important Non-Banking Financial Companies registered with Reserve Bank of India;
- a foreign portfolio investors, who invest either jointly or severally not less than five per cent. of the total offer size of the InvIT or such amount as may be specified by the Board from time to time subject to the compliance with the applicable provisions, if any, of the Foreign Exchange Management Act, 1999 and the rules or regulations or guidelines made thereunder.

Issue Price of the Units and utilisation of funds

- In order to protect the interest of the investors, a pricing cap has been introduced.
  - As per the circular dated 18.01.2018, the price at which units are offered to the strategic investors must not be less than the price determined in the public issue.
  - If there is a situation where the price at which the units are subscribed turns out to be lower than the price discovered in the public issue, the investor shall have to chip in further funds within 2 working days from the date of public issue.
  - *Lock in period:* The units subscribed by strategic investors, pursuant to the unit subscription agreement, will be locked-in for a period of 180 days from the date of listing in the public issue.

Regulations applicable to InvITs

Highlights of InvITs regulations in India

- InvIT need to be in the form of trust set up under Indian Trust Act, 1882.
  - holding of properties through SPVs permitted, where the InvIT has controlling interest
  - Mandatory listing for both publicly offered and privately placed InvITs.
- Leverage restrictions - 49% of the value of InvITs assets, with a requirement to seek credit rating and unit holder's approval if leverage exceeds 25% of InvITs assets
- InvITs to have a minimum asset value of Rs 500 crores
- InvITs to have a minimum offer size of Rs 250 crore at the time of initial offer of units

Comparing REITs and InvITs - similarities

	REITs	InvIT
Tax transparency	On interest income, yes	On interest income, yes
Asset size	Rs 500 crore	Rs 500 crores
Stress on regular income	Only rent producing real estate	Only rent producing infrastructure assets
Investment restrictions	Minimum 80% in rent producing real estate	Minimum 80% in completed, revenue generating infra projects
Listing	Required	required

Comparing REITs and InvITs - dissimilarities

	REITs	InvIT
Public offer	Mandatory	Not mandatory
Investment through SPV	Optional	Mandatory in case of PPP projects
Sponsor net worth	Rs 20 crore per sponsor	Rs 100 crore per sponsor
Number of unitholders	200	20

Eligibility criteria for registration of a InvITs 1/2

- InvITs needs to satisfy the following requirements to be eligible for registration as an InvIT
  - The applicant should be a trust
  - The instrument of trust is in the form of a deed duly registered in India under the provisions of the Registration Act, 1908.
  - Main objective of trust deed should be undertaking the activity of InvIT
  - Responsibilities of the trustee (in accordance with reg 9 of SEBI (InvITs) Reg 2014) to be included in the trust deed
  - Separate entities to be designated as Sponsor(s), Investment Managers and Trustee

Eligibility criteria for registration of a InvITs 2/2

- project implementation agreement to be entered into between the Project Manager, the concessionaire SPV and the Trustee setting out obligations of the Project Manager. In case of PPP projects, obligations shall be in accordance with the concession agreement entered into with the concessioning authority
- Description by applicant of details in respect of proposed activities of the InvIT
- Details in respect of rejection of any previous application for grant of certificate of registration
- Details of any disciplinary action taken by the Board/any other regulatory authority against the applicant/parties to the InvIT/ their associates

Assets that a InvITs may hold

- Reg 2 (z) defines "InvIT assets" as assets owned by the InvIT (directly or through a SPV) and includes all rights, interests and benefits arising from and incidental to ownership of such assets
- The investment conditons applicable to an InvIt can be analysed under the following three heads
  - General Investment conditions applicable to all InvIT
  - Additional investment conditions applicable to publicly offered InvIT
  - Additional investment conditions applicable to privately placed InvIT

General Investment conditions

Investment by the InvIT shall only be made in the following as per the SEBI Regulations and the investment strategy in the offer document/Placement Memorandum

- SPV
- Eligible Infrastructure Projects
- Securities in India
- In case of PPP projects, InvIT shall mandatorily invest in the infrastructure projects through SPV
- invest in at least 2 infrastructure projects
- Not to invest in units of other InvITs
- Hold (directly or through SPV) an infrastructure asset for atleast 3 years from the date of purchase of such asset (other than investment in securities of companies in infrastructure sector other than SPV)
- No schemes shall be launched under the InvIT
- proposed holding of an InvIT in the underlying assets shall be atleast Rs 500 crore

Additional investment Conditions 1/2

- Invest atleast 80% of the value of the assets in completed and revenue generating infrastructure projects
- Remaining 20% of value of the assets can be invested in the following –
  - in under-construction eligible infrastructure projects (directly or through SPV) subject to maximum limit of 10% of the value of the assets of the InvIT
  - Listed or unlisted debt of companies or body corporate in infrastructure sector (debt investment in SPVs excluded)
  - Listed equity shares of the companies deriving 80% of their operating income from infrastructure sector as per previous FY audited accounts
  - Government securities
  - Money market instruments, liquid mutual funds or Cash equivalents

Additional investment Conditions 2/2

Additional investment conditions applicable to privately placed InvIT

- Mandatorily hold atleast
  - one completed and revenue generating eligible infrastructure project and
  - one pre-COD project
- Invest only in
  - eligible infrastructure projects
  - securities of companies in infrastructure sector*
  - partnership interests of LLPs in infrastructure sector*

  *Companies or LLPs deriving atleast 80% of their operating income from infrastructure sector (as per previous FY audited accounts) are called Companies or LLPs in infrastructure sector
- un-invested funds may be invested in liquid funds/government securities/money market instruments/cash equivalents

Eligible Infrastructure Project

- Defined in reg 2(o) to be an Infrastructure Project which before its acquisition by, or transfer to, the Infrastructure Investment Trust, satisfies the following conditions –
  - In case of PPP projects –
    - the Infrastructure Project is completed and revenue generating or
    - the Infrastructure Project is a pre-COD project.
  - In case of Non – PPP projects
    - the Infrastructure Project has received all the requisite approvals and certifications for commencing construction of the project and has been rated by a credit rating agency.

Infrastructure Project

- Defined in reg 2(t) to be any project in infrastructure sector.
  - However if in the books of account of the company executing such project or as per the applicable accounting standards or practices -
    - Revenues/profits generated from the project are treated as rental or leasehold income and/or
    - the immovable assets related to the project are not treated as fixed assets, but as investment properties

    Such project will shall not be considered as an infrastructure project
  - In case of assets such as hospitals or hotels
    - Leasing of land or building on which hospital or hotel is located shall not be considered as an infrastructure project.
    - Revenues generated from operation and management of a hospital or hotel shall be considered as Infrastructure Project.

PPP Projects 1/2

- Defined in reg 2(kk) as an infrastructure project undertaken on a Private-Public Partnership basis between a public concessioning authority and a private SPV concessionaire selected on the basis of open competitive bidding.
- Pre-COD project defined in reg 2(ll) as an infrastructure project which –
  - has not achieved commercial operation date as per the relevant project agreements including the concession agreement, power purchase agreement or any other agreement of a similar nature entered into in relation to the operation of a project or any agreement entered into with the lenders and
  - Has
    - achieved completion of at least 50% of the construction of the infrastructure project as certified by an independent engineer of such project or
    - expended not less than 50% of the total capital cost set forth in the financial package of the relevant project agreement.

PPP Projects 2/2

- Non-PPP Projects defined in reg 2(gg) as an infrastructure project that is not a PPP project.
- Concession agreement defined in reg 2(j) as an agreement entered into by a person with a concessioning authority for the purpose of implementation of the project as provided in the agreement

Holding of properties through SPVs

- SPV - defined in reg 2 (xx) to be a company or LLP
  - in which the InvIT holds or proposes to hold controlling interest and atleast 51% of the equity share capital or interest ; and
  - which holds atleast 90% of its assets directly in infrastructure projects
  - does not invest in other SPVs; and
  - which is engaged only in activities pertaining to and incidental to the underlying infrastructure projects
- Reg 18 (3) permits InvIT to invest in eligible infrastructure projects through SPV. However it places essential restrictions regarding holding of properties through SPVs

Holding properties through SPVs -2

- No shareholder or partner of the SPV must have any right to prevent the InvIT from ensuring compliance with the provisions of the Regulations and an agreement shall be entered with such shareholders/partners to that effect prior to investment in the SPV
- In case the SPV is a company/LLP, at least one representative/ one representative as designated partner, on the board/ to the LLP of the SPV shall be nominated by the Investment Manager, in consultation with the trustee and ensure that such representative attends all the board meetings/meetings of the designated partners, of the SPV
- It is to be ensured by the investment manager that the voting of the InvIT is exercised in every meeting including the AGM of the SPV

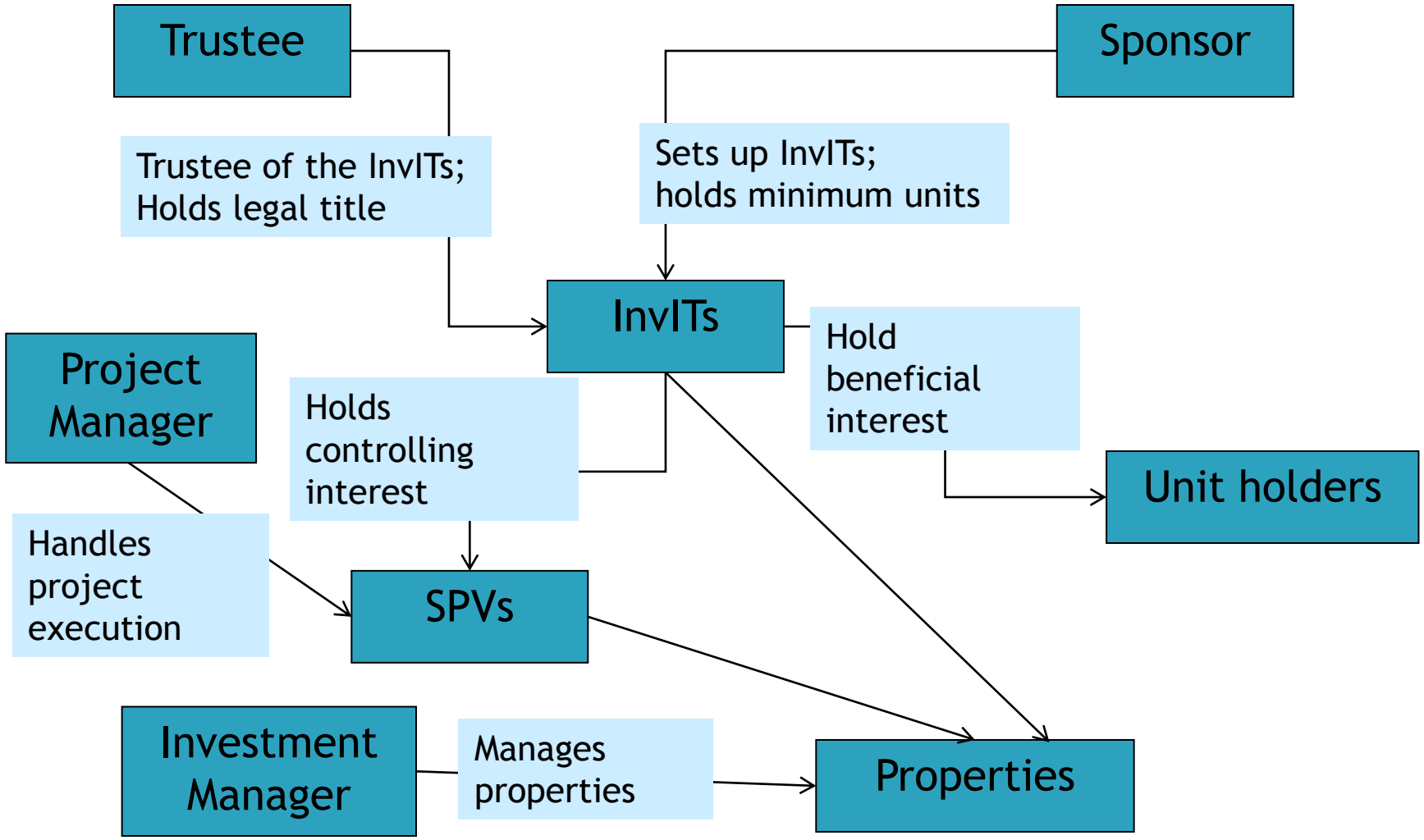
Holding properties through SPV -3

- Are the dividend distribution requirements applicable to SPV too?
  - It Seems logical; if SPVs are allowed to retain profits, the whole purpose of dividend distribution mandate gets defeated
- Is SPV subject to leverage restriction?
  - Reg 20 (1) refers to “consolidated borrowings” so the borrowings of the SPV need to be added together
  - Borrowings are a proportion of InvIT assets
- Is the SPV subject to the same restrictions are the InvIT?
  - Definition of “InvIT assets” in reg 2 (z) includes SPV assets too

Co-investment in properties

- An InvIT may be a joint investor in properties
- Reg 18 (12) places conditions for co-investment
  - Investment terms to the co-investor should not be more favourable
  - No rights to the co-investor, by virtue of the investment, which prevent the InvIT from complying with the reg
  - Agreement with the co-investor to provide for minimum distributions; pro-rata share of distributions; dispute resolution mechanism

Graphical illustration of parties to an InvIT



Parties to an InvIT

- "Parties to an InvIT" [reg 2 (ii)]
  - Sponsor(s)
  - Redesignated sponsor(s)
  - Trustee
  - Investment Manager
  - Project Manager
- Other parties
  - Principal valuer
  - Valuers other than principal valuer
  - Auditor

Sponsor

- Sponsor is the entity that puts up the entire show. Reg 2(yy) defines Sponsor as company(ies) or LLP(s) or body corporate(s) who set(s) up the InvIT and in case of PPP projects the lead member of the concessionaire SPV
- As per the eligibility criteria laid down by reg 4(d) the sponsor should have
  - Minimum Net worth of Rs 10 crores, on an individual basis, if it's a body corporate or a company,
  - Net tangible assets with a minimum value of Rs 10 crores if its a LLP

  Eligilibility criteria of project documents to define net worth/net tangible assets in case of PPP projects
  - Sound track record required in development of infrastructure or fund management in the infrastructure sector from the Sponsor/its subsidiary/its holding company on an individual basis.

  As per explaination sound track record implies minimum experience of 5 years, in case the sponsor is a developer, it implies that a minimum of 2 projects of the sponsor to have achieved financial closure.

Re-designated sponsor

- Reg 2(tt) defines Re-designated sponsor as person(s) who has/have assumed the responsibility of the sponsor(s) [as provided under Reg 12] from the person(s) designated as sponsor.
- Following compliances need to be made by the re-designated sponsor if it/they want to sell its/their units to any other person -
  - It/they shall arrange for another person(s)/entity(ies) to act as the re-designated sponsor(s) having a net worth of not less than rupees 20 crore, prior to the sale of units by it/them. (Provided such units may be sold to existing sponsor)
  - An exit option to be provided to the unit holders, in accordance with guidelines as may be specified, by the proposed buyer(s).

Trustee – eligibility

- Reg 2(aaa) defines trustee to be a person who holds the InvIT assets in trust for the benefit of the unit holders in accordance with the reg
- Reg 4 (2)(f) sets out the following eligibility criteria for the trustee
  - The trustee is either -
    - Registered as Debenture Trustee under SEBI(Debenture Trustees) Regulations, 1993 and is not an associate of the Investment manager/sponsor or
    - Minimum of 50% of its directors are independent and not related parties to the InvIT, if the trustee is an associate company of the sponsor/Investment Manager
  - And should not be trustee
    - Of another InvIT or
    - in an Alternative Investment Fund engaged in infrastructure sector

Investment Manager – Eligibility

- Investment Manager is the operating functionary of a InvIT
- Eligibility
  - The Investment Manager has
    - a minimum networth of Rs 5 crores, if it's a body corporate
    - a minimum net tangible assets of Rs 5 crores, if it's a LLP,
  - At least 5 years experience in fund management/ advisory services/ development in the infrastructure sector
  - At least 2 employees having at least 5 years experience individually in fund management/ advisory services/ development in the infrastructure sector
  - At least 1 employee having at least 5 years experience in the sub-sector(s) in which the InvIT has invested/proposes to invest
  - an office in India from where the operations relating to the InvIT is to be conducted
  - Enter into an investment management agreement with the Trustee

Project Manager

- For each SPV , a Project Manager is appointed by the InvIT
- Reg 2(nn) defines Project Manager to mean
  - the person designated as Project Manager by the InvIT and who is responsible for project execution
  - in case of PPP projects, Project Manager mean the entity responsible for execution and achievement of project milestones in accordance with the concession agreement (i.e. the concessionaire SPV)
- Reg 11 lays elaborate responsibilities of Project Manager
  - Undertake operations and management of the InvIT assets
  - In case of under construction projects
    - undertake the operations and management of the projects
    - oversee the progress of development, approval status and other aspects of the project
  - Ensure revision of the concession agreement if required for compliance with provisions of these Regulations
  - Undertake all obligations in respect of achieving timely completion of the infrastructure project viz. project implementation, operation, maintenance and management of infrastructure project in terms of the project management agreement

Auditor

- Appointment
  - To be appointed by the Investment Manager for a period of not more than 5 consecutive years
  - If the auditor is not an individual, may be reappointed for another 5 consecutive years subject to approval of unit-holders in the annual meeting as per reg 22
- Audit frequency
  - At least twice every year
  - Audit report to be submitted to stock exchanges within 45 days of end of financial year ending March/ half-year ending September to the Designated Stock Exchanges

Valuer

- Reg 2(ddd) defines valuer to mean any person who
  - Is a "registered valuer" under Section 247 of the Companies Act, 2013 and
  - has been appointed by the Investment Manager to undertake valuation of the InvIT assets
- Who can be valuer
  - Principal valuer should have an experience of at least 5 years in real estate valuation
  - should not be an associate of the sponsor(s)/Investment Manager/Trustee

Fund raising – Issue of units & allotment 1/5

- Funds may be raised by an InvIT by way of
  - Units issued under private placement and/or
  - IPO/FPO
- Units of InvIT need to be mandatorily listed irrespective of the mode of funding

Conditions for raising of funds by way of private placement

If InvIT intends to invest in under-construction projects, value of which is more than 10% of the value of the InvIT assets

- it shall raise funds
  - by way of private placement only
  - from Qualified Institutional Buyers and body corporate, whether Indian or foreign (subject to guidelines of RBI and the government)
  - with minimum investment from any investor of rupees 1 crore
  - from not less than 5 and not more than 1000 investors
- InvIT to file the draft placement memorandum for undertaking private placement of units with the Board along with the application for registration

Fund raising – Issue of units & allotment 2/5

Conditions for raising of funds by way of public offer

If InvIT intends to hold at least 80% of its assets in completed and revenue generating infrastructure projects

- Initial issue of units shall be by way of initial offer only
- subsequent issue of units after initial offer may be by way of follow-on offer, preferential allotment, qualified institutional placement, rights issue, bonus issue etc.
- Minimum subscription by any investor shall be at least INR 5 lacs
- value of the units proposed to be offered to the public in initial offer shall be at least 25% of the value of the InvIT
- price determination of InvIT units may be through the book building or any other prescribed process
- Units may be offered to both residents and foreigners (subject to guidelines of RBI and the government)

Fund raising – Issue of units & allotment 3/5

- Prior to any offer Investment Manager to file draft offer document with the designated stock exchange(s) and the Board at least 21 days before filing final offer document to the designated stock exchange
- draft offer document will be hosted by the Designated Stock Exchanges on their websites for public comments for at least 10 days
- Board may require the Investment Manager to make modifications in the draft offer document in investors interest.
- Trustee to ensure that before filing of the final offer document with the Designated Stock Exchanges all comments from the public/board received on the draft offer document are addressed
- The InvIT may issue the final offer document to the public in case no modifications suggested by the Board in the draft offer document within 21 working days from the date of filing.
- Draft and final offer document to be accompanied by a Due Diligence Certificate
- final Offer Document to be filed with the Designated Stock Exchanges and the Board at least five working days before opening of the offer
- InvIT to undertake the initial offer or follow-on offer within 6 months from the date of last issuance of observations by the Board/filing of final offer document with the Designated Stock Exchanges

Fund raising – Issue of units & allotment 4/5

- application for subscription to be accompanied by
  - a statement containing the abridged version of the offer document
  - summary of the terms of issue
- Initial offer and follow-on offer to be open for subscription for a maximum period of 30 days
- In case of over-subscriptions, InvIT to allot units on a pro-rata basis subject to minimum subscription amount of INR 5 lacs
- InvIT to allot units /refund money within 10 working days from the date of closing of the issue
- InvIT to issue units in only in dematerialized form
- InvIT to refund money to the applicants if
  - it collects subscription of amount less than 75% of the issue size as specified in the final offer document, money be refunded to all applicants
  - the moneys received is in excess of the extent of over-subscription as specified in the final offer document money be re funded to the extent of the oversubscription (right to retain such over subscription cannot exceed 25% of the issue size)

Fund raising – Issue of units & allotment 5/5

- the number of public subscribers to the initial offer is less than 20 money be refunded to all applicants
- On failure of Investment Manager to allot/list units within the specified time, Investment Manager to pay interest @15% per annum

Conditions for fund raising common to both public offer and private placement

- The InvIT is registered with the Board
- The initial offer size shall be at least Rs. 250 crore
- the value of the proposed holding of the InvIT in the underlying assets shall be at least INR 500 crore
- On failure to undertake offer of units by the InvIT within 3 years of registration with the Board, it shall surrender its certificate of registration to the Board and cease to operate as an InvIT (Board may extend the period by another one year, the InvIT may later apply for registration)
- All unit holder of the InvIT enjoys equal voting or any other rights and there are no multiple classes of units of InvITs

Distributions/pay-outs

- Atleast 90% net distributable income after tax of the SPV shall be distributed to the InvIT in proportion of its holding in the SPV;
- Atleast 90% of the net distributable cash flow of the InvIT shall be distributed to the unit holders
- Distributions shall be made on a half yearly basis
- In case the asset is sold by the InvIT/SPV or in case of a PPP project, if the equity shares in the SPV is sold by the InvIT then the InvIT may
  - re-invest the gains in another infrastructure asset or
  - distribute the same to the unit holders

Disclosures in offer documents/placement memorandum and advertisements

- Offer document/placement memorandum to contain material, true, correct and adequate disclosures to enable the investors to make an informed decision
- Offer document/ placement memorandum shall
  - not be misleading or contain any untrue statements or mis-statements
  - not provide any guaranteed returns to the investors
  - Include other specified disclosures
- Offer document to include all information specified under Schedule III of the reg
- Placement memorandum to contain all the information specified under reg 15(4)
- No advertisement pertaining to issue of units by an InvIT which makes private placement of its units
- In respect of advertisements pertaining to the offer of units by an InvIT under public offer of its units
  - advertisement material not to be misleading and not to contain anything irrelevant to the contents of the offer document
  - an advertisement containing highlights also to contain risk factors with equal importance
  - advertisements to be in accordance with guidelines prescribed by the Board

Listing and trading of units 1/2

- Units of InvITs shall be listed on a recognized stock exchange
- listing of the units will be in accordance with the listing agreement
- units of the InvIT listed in the designated stock exchanges to be traded, cleared and settled as per the bye-laws of designated stock exchanges, Depositories Act and other specified conditions
- Redemption of units by the InvIT to the unit holders only by way of a buyback as per the Board's guidelines specified at the time of delisting of units
- units to be listed on the Designated Stock Exchanges unless delisted under reg 17
- Any person other than the sponsor(s) holding units of the InvIT prior to initial offer shall hold the units for a period of at least one year from the date of listing of the units

Listing and trading of units 2/2

- In respect of publicly offered InvIT
  - minimum public holding for the units shall be 25% of the total number of outstanding units
  - minimum number of unit holders, other than the sponsor(s), forming part of public shall be 20, each holding a maximum of 25% of the units of the InvIT
  - its units shall be mandatorily listed on the designated stock exchange(s) within 12 working days from the date of closure of the initial offer (this requirement not applicable if minimum subscription requirements and minimum subscriber requirements are not met)
  - Trading lot on the designated stock exchange shall be INR 5 Lacs
- In respect of privately placed InvIT
  - minimum number of unit holders shall be 5, each holding a maximum of 25% of the units of the InvIT
  - its units shall be mandatorily listed on the designated stock exchange(s) not later than 30 working days from the date of final closing
  - Trading lot for the purpose of trading of units shall be INR 1 crore

Delisting of units 1/2

- Trustee shall apply for delisting of units of the InvIT to the Board and designated stock exchanges if
  - the public float falls below 25% of the total number of outstanding units
  - the number of unit holders of the InvIT falls below
    - 5 in case of privately placed InvIT
    - 20 in case of publicly placed unit
  - there are no projects/assets remaining under the InvIT for not more than six months and InvIT proposes to invest in no projects in future
  - delisting required by Board or Designated Stock Exchanges for violation of the listing agreement or reg
  - sponsor(s)/Investment Manager requests for delisting is approved by unit holders as per reg 22
  - unit holders apply for delisting as per reg 22

Delisting of units 2/2

- application for delisting may be approved or rejected by the Board and the Designated Stock Exchanges
- The Board may instead of delisting, provide additional time to the InvIT or parties to the InvIT to comply with the reg
- Board may reject the application of delisting and take any other action
- procedure for delisting of units of InvIT shall be as per listing agreement and procedure specified by the Board and Designated Stock Exchanges
- Post delisting, InvIT shall surrender its certificate of registration to the Board and no longer undertake activity of an InvIT
- InvIT and parties to the InvIT continue to be liable for all acts of omissions and commissions even after surrender of registration

Borrowings and deferred payments

- Aggregate consolidated borrowings and deferred payments of the InvIT not to exceed 49% of the value of the InvIT assets
- Where aggregate consolidated borrowings and deferred payments of the InvIT exceed 25% of the value of the InvIT assets
  - credit rating be obtained from a registered credit rating agency
  - approval of unit holders to be obtained
- If above specified conditions breached on account of market movements of the price of the underlying assets/securities, the Investment Manager
  - shall inform it to the trustee and
  - ensure that the breached conditions are satisfied within 6 months of such breach.

Valuation 1/2

- Reg 21(2) defines full valuation to include
  - detailed valuation of all assets of the InvIT
  - physical inspection of every infrastructure project
- When is valuation done?
  - Full valuation to be done at least once in a year, at the end of the financial year ending March within two months from the date of end of such year
  - half yearly valuation, for the half-year ending September, of the assets of the InvIT to be conducted by the valuer for a publicly offered InvIT. Half yearly valuation report shall be undertaken within one month from the date of end of such half year.
  - full valuation of all the InvIT assets prior to any issue of units by offered InvIT other than bonus issue (valuation report not to be more than 6 months old at the time of such offer)
  - full valuation of the specific project to be undertaken for any transaction of purchase or sale of infrastructure projects, whether directly or through SPVs for publicly offered InvITs and the transaction shall be at atleast 90%/not more than 110% of the assessed value of the property for sale/purchase of real estate property respectively

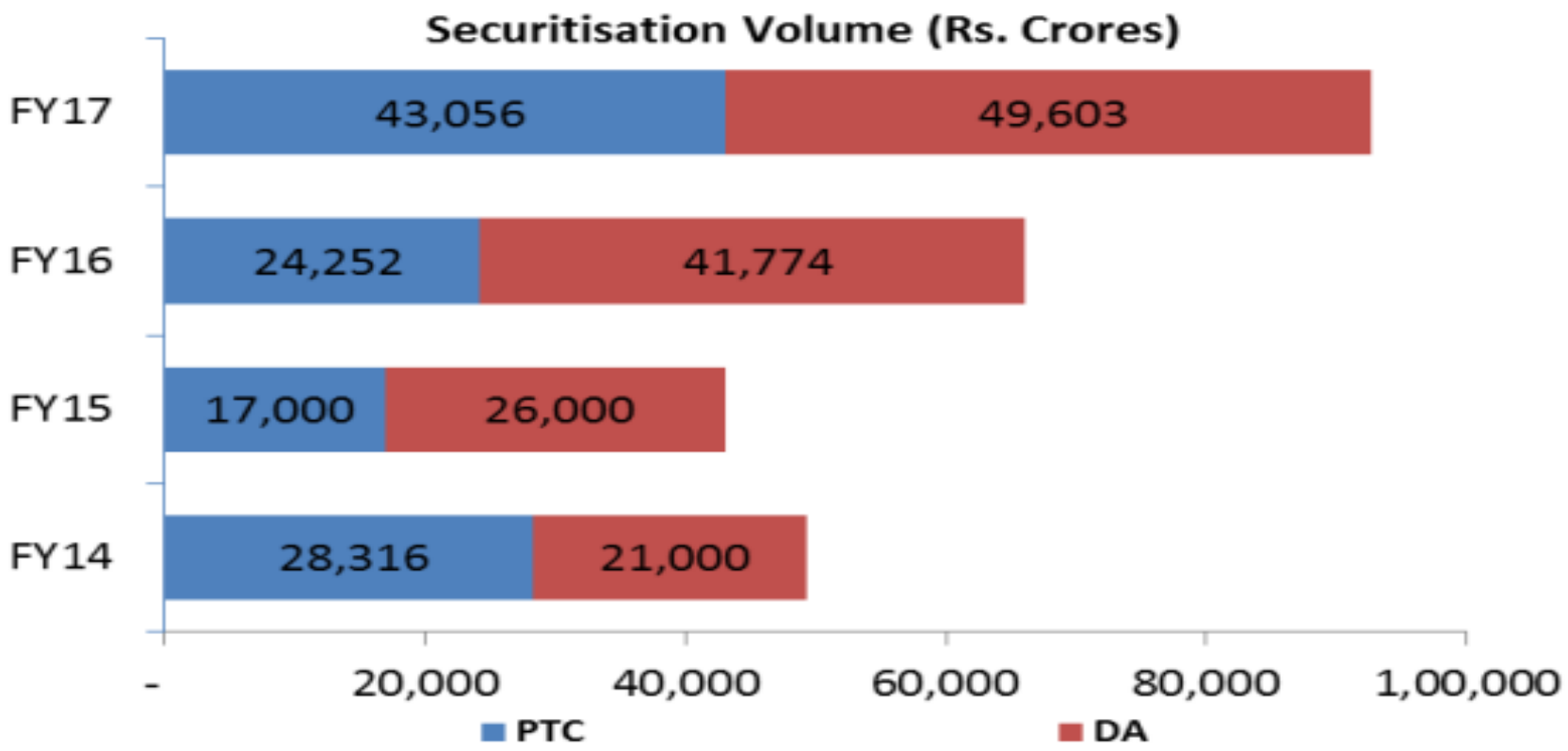
Valuation 2/2

- Full valuation, of the infrastructure project under consideration, in case of any material development affecting valuation of the assets of a publicly offered InvIT. To be done within two months of the relevant event date and disclosure to the Trustee and the Designated Stock Exchanges within 15 days of such valuation

- Valuation report to be submitted by the Investment Manager to the Designated Stock Exchanges within 15 days from the receipt of report
- Reg 21(9) requires mandatory rotation of valuer
  - No valuer to carry valuation more than 4 years consecutively
- Valuer not to value those assets, in respect of which which it has either been involved with the acquisition /disposition to a vendor/purchaser associated with the InvIT within the last 12 months

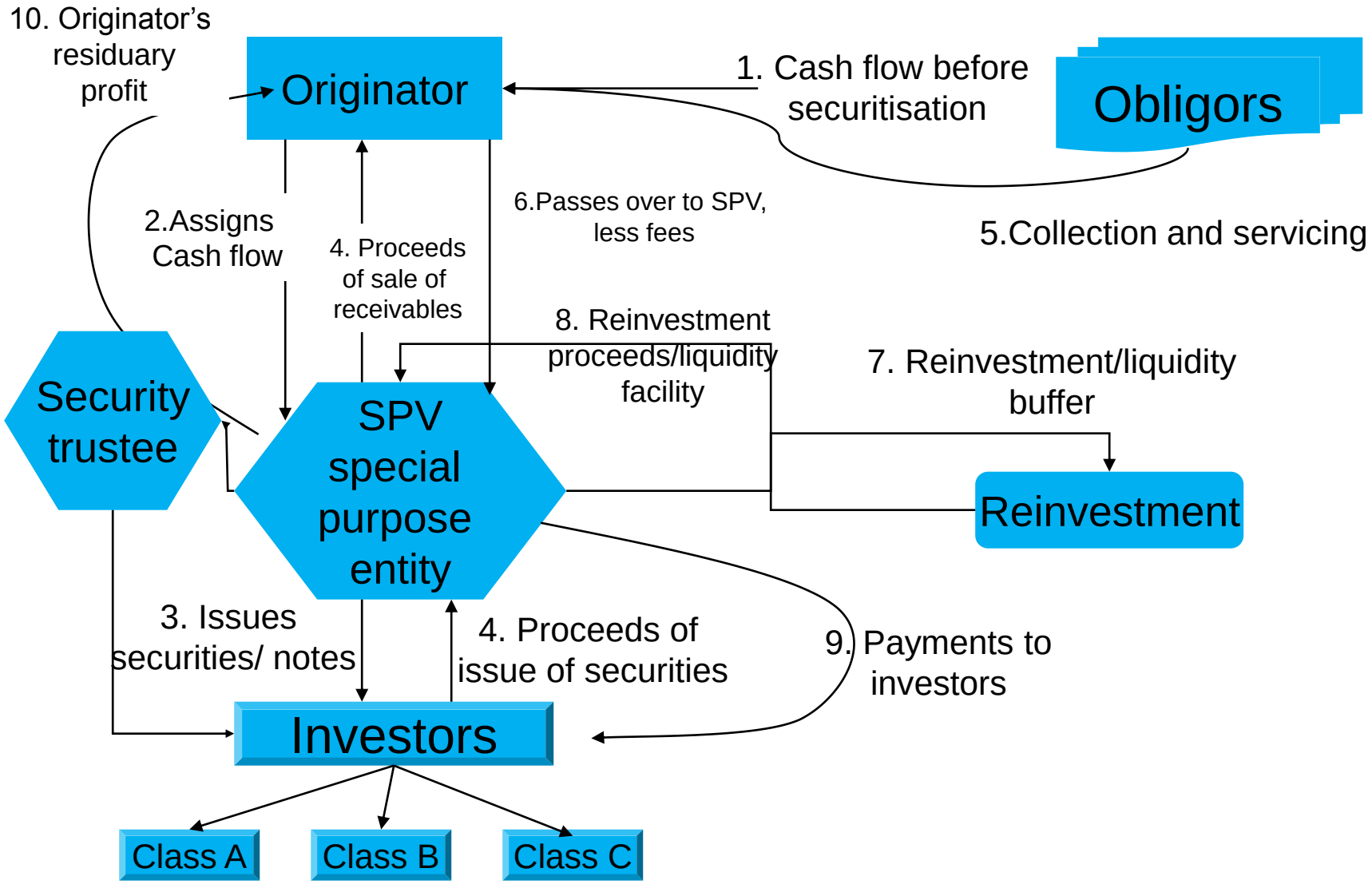
Regulations applicable to Securitisation and Direct Assignment in India

Securitisation & DA Volume (upto 31st March, 2017)

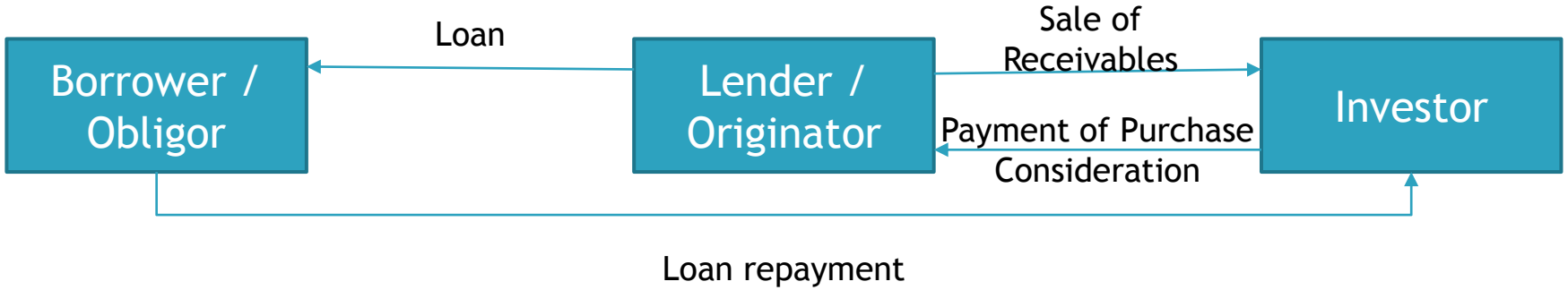


Source: http://www.careratings.com

Basic process of securitisation (PTC route)



Process of Direct assignment transactions



Securitisation vs. Direct Assignment

Particulars	Securitisation	Direct Assignment
Legal format	Assignmnet Required	Assignmnet Required
True Sale	Yes	Yes
Transferability of single loan	No	Yes
Bankruptcy remoteness	Yes, provided SPV does not get consolidated	Yes
Special purpose vehicle	Yes	No
Participation by multiple investors	Yes	Yes, but as joint owner
Nature of investment made by the investor	Purchase of securities of SPV	Purchase of underlying pool
MHP	Applies	Applies
Risk retention	Usually by credit enhancement	Mandatorily Pari passu
Rating of the securities	Usually uplifted, and may go upto AAA	No question, as investor buys a pool of loan
Upfront encashment of profit	Possible	Required

Securitisation vs. Direct Assignment - 2

Particulars	Securitisation	Direct Assignment
Due diligence by investor	Only based on the evaluation of the securities of SPV	Based on individual loans
Use of excess spread to meet losses	Most commonly yes	NO
Servicing fee	Yes	Yes
Subordination of servicing fee	Not common	Yes, possible
Cap on extent of investment	20%	No such cap
Partial assignment	Yes	Necessarily yes
Exposure of the investor for concentration norms	On the underlying	On underlying loans
Accounting in the nooks of the investor	Purchase of a security	Purchase of loans
MTM requirements	Applicable	Not applicable
Capital relief	Capital eaten up to the extent of first loss support	Full capital relied, as originator provides no credir enhancement
Pricing	Based on the rating of the resulting securities	May be worked out after considering losses and prepaymnets upto certain level
Simplicity	Not usually very simple to execute	Very simple to execute
Tax issues	Tax issues currently faced on taxation of SPVs	No tax issues at all, as direct transfer of the assets
Distribution tax	Does not apply	Does not apply
Off balance sheet treatment	Yes, subject to conditions	Yes, subject to conditions

Securitisation Guidelines in India

- There are separate guidelines for securitisation of standard and non-standard assets
- RBI issues guidelines for banks and NBFCs only
- First set of guidelines for securitisation of standard assets in 2006
  - Revised guidelines in 2012
- 2012 Guidelines of RBI distinguish between
  - Direct Assignment; and
  - Securitisation route
    - Essentially by way of issuance of securitised paper (commonly known as PTCs in India)
- Thereafter, guidelines for reset of credit enhancements were issued
  - Essentially allowing credit enhancements to be released as the securitised papers retire
  - Globally there is no concept of reset of credit enhancements

So, what is securitisation?

- Guidelines do not define "securitisation"
  - Descriptive features are given such as "Securitisation involves pooling of homogeneous assets and the subsequent sale of the cash flows from these asset pools to investors".
  - Marketplace meaning of securitisation to be taken:
    - transfer of receivables to SPVs
    - SPVs issuing securities which are liquidated from out of the cashflows
    - Supported by credit enhancements, but primarily, repayments come from the transferred cashflows
  - Reference to SPVs not there in the definition of securitisation; however Guidelines refer frequently to securities of SPV
- Borderline of distinction between "securitisation" and "direct assignment" may be thin:
  - It is not necessary for SPVs to issue pass through certificates
  - If the originator transfers assets, and SPV issues bonds, it may seem like a direct assignment
  - Likewise, if a single investor buys all the securities of the SPV, it is no different from a direct assignment
  - In the language of the Guidelines, the only difference seems to be "securitisation", that is, existence of securitised paper
- Essential difference between securitisation and direct assignment is – whether the assignee is a real life operating entity, or a special purpose entity solely deriving its cashflows from the transferred assets

What all can be securitised?

- Only performing assets
  - Transfers of non-performing assets are covered by separate guidelines
- Homogenous pool:
  - Similar risk characteristics and underlying collateral is same
- Assets that cannot be securitised:
  - Single loans
  - Revolving credit facilities:
    - Note there is no bar on revolving structure of securitisation
  - Purchased assets
  - Loans with bullet payment of principal and interest

Revolving credit facilities

- What are revolving credit facilities:
  - Typically a line of credit where the customer is allowed to draw up to a limit
  - Can pay at any time
  - Once paid back, the limit is restored
  - Examples – cash credit, credit cards
- Revolving credit facilities are different from reinstating structures used in securitisation
  - The pool is dynamic in nature and receivables continue to be reinstated
  - Very commonly used structures internationally
  - RBI does not restrict revolving structures

Trade receivables securitization

- Trade receivables with tenor up to 12 months discounted/purchased by NBFCs from their borrowers will be eligible for securitisation
  - Only those loans/receivables will be eligible for securitisation where a drawee of the bill has fully repaid the entire amount of last two loans/receivables within 180 days of the due date

Purchased Assets

- The bar on purchased assets seems difficult to understand
- It would have been understandable if there was a MHP requirement here as well
- But a straight bar on purchased assets is not reasonable
  - For example, a bank may have bought the entire portfolio long time back,
  - may have even added its own funding
  - A bank may have bought different loans from different sellers, and may now want to resell the pool
    - The risk characteristics of the individual assets and the pool may be very different
- The prohibition becomes retroactive:
  - Assets bought prior to the new Guidelines cannot be securitised post the Guidelines

Securitisation Exposures: ABS/MBS

- Banks are also not expected to securitize their investments in ABS/ MBS
- Coupled with restriction on securitisation of purchased assets, whether purchased whole loans, or fractional interests, or ABS/MBS cannot be securitised
- However, no bar on:
  - Securitisation of participation rights, or syndicated loans
  - Loans acquired on purchase of entire portfolio of a bank exiting business

Loans with bullet payment terms

- Loans will bullet payments cannot be securitised:
  - Guidelines say, both interest and principal payable on maturity
  - General meaning of a bullet loan is principal payable on maturity
    - Interest may be serviced regularly
- Idea is understandable
  - In absence of any principal/interest payments during the MHP, there is no demonstration of the quality of the loan
    - Hence, seller has not taken any risk at all
- The prohibition burdened with lots of exceptions:
  - Agricultural loans of upto 24 months maturity
    - Provided the borrower has paid, within 90 days of due date,
      - past 2 loans of maturity upto 1 years
      - Past 1 loan with maturity of more than 1 year
- Trade receivables of tenure upto 12 months, discounted or purchased by banks
  - Provided the obligor/drawee has paid last 2 receivables within 90 days of due date

Who can be the transferee?

- The Guidelines do not lay down who the transferee can be.
- As regards securitisation
  - Implicit understanding is that it is the SPV
- As regards direct transfers
  - No restriction apparently
  - Hence, banks or others may be transferees
  - Of course, the part of the Guidelines laying down requirements for the investor/ buyer will apply only if the buyer from the financial system

Minimum Holding Period

- MHP runs:
  - From the date of full disbursement or purchase of the asset (in case of asset-backed loans)
  - To the date of transfer
- Since MHP requirements in the Table is number of instalments, the instalments payable before full disbursement are to be ignored
  - Note MHP applies to the loan in question and not the borrower
  - For example, borrower has repaid the existing loan, and granted a new loan – can the new loan be sold?
    - No
  - Difficult question – however, if borrower took original loan, and before maturity, an add-on loan was given, can the whole loan be securitised:
    - Answer should be, Yes.
- MHP applies to all loans and not the pool
  - That is, assets not complying with the MHP to be filtered out
- MHP does not apply to agri loans and trade receivables of bullet maturity
  - Where track record of performance is seen with reference to previous payments
  - However, it is obviously important that the borrower must have had past track record with the originator

MHP Matrix

	Minimum Instalments to be paid before securitisation			
	Repayment frequency - Weekly	Repayment frequency - Fortnightly	Repayment frequency - Monthly	Repayment frequency - Quarterly
Loans with original maturity up to 2 years	12	6	3	2
Loan with original maturity of more than 2 years and up to 5 years	18	9	6	3
Loans with original maturity maturity of more than 5 years	--	--	12	4

Risk retention requirements

- The discussion on risk retention has been the theme of regulatory reaction to the subprime crisis
- The risk retention requirements were imposed by EU regulators long time back in form of article 122a of CRD directive.
  - The terms horizontal slice, vertical slice and T slice came from there.
- EU regulations provide for 4 forms of risk retention:
  - Vertical slice
  - First loss piece
  - Originator risk retention in case of revolving transactions
  - Retention of randomly selected loans, where the pool consists of at least 100 obligors
- The extent of risk retention in both US and European regulations is 5%

MRR Requirements under RBI Guidelines

- The essence of the Guidelines is to impose following MRR requirements (required MRR or RMRR):
  - 5% for transactions with original maturity of 24 months or less
  - 10% for transactions with original maturity exceeding 24 months
- Both of these are classed into 4 categories:
  - No tranching, no first loss credit enhancement
  - No tranching but first loss credit enhancement
  - Tranching but no first loss credit enhancement
  - both tranching and first loss credit enhancement
- Conceptually, the Guidelines have not properly appreciated distinction between first loss credit enhancement and tranching
  - For example, if there are Senior and Junior securities, the retention of junior securities by the originator is nothing but first loss support
- However, the Guidelines have taken first loss credit enhancement to refer to off balance sheet support (e.g., guarantee), over collateralisation and cash collateral.

So, quick understanding of the MRR

- No tranching, no first loss credit enhancement: RMRR % of securities
- No tranching but first loss credit enhancement:
  - the whole of the first loss support,
  - if first loss support < RMRR, (RMRR-first loss)% of securities
- Tranching but no first loss credit enhancement:
  - RMRR% of the value of securitised pool in the equity tranche
  - If equity tranche < RMRR, (RMRR-equity tranche)% of securities
- both tranching and first loss credit enhancement
  - Total exposure of the originator in first loss support + equity tranche to be RMRR
  - If less, the balance in senior securities

What counts as MRR?

- MRR should be based on percent of the principal value
  - Investment in IO strip not be counted
- Several questions:
  - What if pool sold at more than par value:
    - Will MRR be based on outstanding pool value:
      - Clearly, Guidelines provide for RMRR% of securities of the SPV
      - Issue price Securities need not be the same as par value of pool sold

Maximum retained risk

- The maximum exposure of the bank should not exceed 20% of issued securities, including
  - Credit enhancements, whether funded or funded + equity tranche
  - Any investments in senior tranches
  - Any liquidity support
- The excess will be straight deduction from capital
  - Guidelines provide for 1111% risk weight
- This is surely very different from Basle II requirements
  - Under Basel II, if there is no substantive risk transfer, the transaction does not qualify for capital relief
  - Not qualifying for capital relief is not the same as capital deduction.
- Guidelines clarify that if amortisation of the pool results into increase of originator interest, the Guidelines will not be deemed breached
  - Same will arguably apply to repayment of senior tranches too

Does the MRR remain constant through the term?

- One of the big confusions in the Feb 2006 Guidelines was that the first loss support had to remain constant through the term of the transaction
- The Guidelines (# 1.3.4) make it very clear that amortisation of the RMRR is possible
- In other words, RMRR has to remain constant as percentage, not as amount
  - Payback of RMRR, not faster than the payback of the senior classes, is therefore possible

Direct Assignment: What is eligible and what is not?

- Ineligible assets are the same as in case of securitisation
  - Revolving credits
  - Purchased loans
  - Bullet repayment loans
- Guidelines do not apply to the following:
  - Transfers that happen with the request of the borrower
  - Inter-bank participants
  - Trading in bonds:
  - Sale of entire portfolio upon exit decision
  - Consortium or syndication arrangements in case of CDR
  - Specific exemptions

MHP and MRR

- MHP is the same in case of securitisation
- However, MRR becomes curious
  - The Guidelines require retention of 10% cashflows
  - the retained risk is a pari passu risk
- Guidelines also say, seller should not hold back IO strip
- Legal validity of the proportional transfer

Profit recognition in case of direct assignments

- The profit recognition rule is the same as in case of securitisations
- This is, however, most illogical
  - Since the originator is not exposed to any credit risk of the transferred pool in case of direct assignments, the question of the seller not recognising a profit does not arise at all
  - Selling holds only a pari passu interest
    - So, if the seller transfers 90% of the pool, there is no reason for the seller not to recognise 90% of the profit, whether realised or unrealised