INDIA
SECURITISATION
REPORT, 2019
Preface

It is at least 11 years since the full-blown impact of the Global Financial Crisis hit the world of finance, and it is arguable as to whether we are fully settled down as yet. Certain things, it seems, will either never be back, or at least not in the same form. May be the multi-layered synthetic CDOs were far too imaginative to be back on the scene. However, most of the standard asset classes are globally back to their pre-Crisis levels.

The root of the crisis was subprime lending. Writing on an IMF Blog, an author says:

Looking back today, the pressure points seem obvious. But they were less obvious at the time. Most economists failed to predict what was coming. It is a sobering lesson in groupthink.

What were these pressure points? At the core was financial innovation that vastly outpaced regulation and supervision. Financial institutions—particularly in the United States and Europe—went on a frenzy of reckless risk-taking. This included relying less on traditional deposits and more on short-term funding, dramatically lowering lending standards, pushing loans off balance sheets through murky securitizations, and more generally, shifting activity to the hidden corners of the financial sector that were subject to less regulatory oversight.

For example, the market share of subprime mortgages in the United States reached 40 percent of overall mortgage-backed securities by 2006—up from almost nothing in the early 1990s.

It is over-optimism to think that subprime lending, of some sort or the other, will go away from the system. Periodically, lenders do get over-exuberant, and start lending, jettisoning prudential safeguards learnt over years of lending business. The syndrome becomes cyclical, until it is ready to burst. This has happened in the past, and will continue to happen, securitisation or no securitisation.

The moment securitisation enters the scene, there is capital market connectivity, and coupled with the capital market investors who

---

themselves were sitting with layers of leverage, the asset crisis soon blows up into a financial crisis of global proportions.

Indian securitisation was much less affected by the Crisis, than by internal regulatory and tax regime. However, most of the tax issues, including some apprehended issues with GST, now stand resolved.

The remaining issues may be with stamp duty and minor inflexibility of the RBI Guidelines. In any case, transaction volumes, variety, and investor-base are all showing signs of a market that is ready to take off to the next level. Priority-sector lending was not the economic mainstay of securitisation – hence, the fact that that segment is now better served by PSLCs is only good for putting the focus on the economics of securitisation transactions.

This small booklet that we prepare, especially on the occasion of the Securitisation Summit, is an attempt to put together some relevant write-ups on the Indian securitisation. This edition includes write-ups on IFRS, true sales and other important issues.

We are hoping the participants at the Summit, and other stakeholders, will find this publication useful.

Kolkata

VINOD KOTHARI

7th May, 2019
Contents

Preface .......................................................................................................................... 5
Contents ......................................................................................................................... 7
Detailed Contents .......................................................................................................... 8
List of figures .................................................................................................................. 11
State of securitisation in India ....................................................................................... 12
Innovative structures in the Indian securitisation market .............................................. 18
Indian Securitisation Market: A primer ......................................................................... 24
Regulatory framework for securitisation in India ......................................................... 37
Assignment of receivables in financing transactions: Truly a sale or funding in disguise? .................................................. 44
FPI Investments in Indian Securitization Market ......................................................... 58
FAQs on section 115TCA of the Income Tax Act, 1961 ............................................. 64
GST on securitisation transactions ............................................................................. 73
Accounting treatment of securitisation transactions in India ........................................ 86
Accounting for Direct Assignment under Indian Accounting Standards (Ind AS) ................. 98
Servicing Asset and Servicing Liability: A new by-product of securitization under Ind AS 109 .................................................. 107
Global securitisation market ....................................................................................... 113
Authors ......................................................................................................................... 129
Detailed Contents

State of securitisation in India.................................................................12

Securitization volumes in India reach record high in 2019... 12

Innovative structures in the Indian securitisation market....................18

1. India – RE Opportunities Trust – Project Loans
Securitisation.........................................................................................18

2. Ess Kay Fincorp Limited – Persistent Securitisation ..............19

3. Kogta Financial India Limited – Covered Bonds .................21

4. OPC Asset Solutions Private Limited – Lease rental
securitization .......................................................................................22

Indian Securitisation Market: A primer ...........................................24

Direct Assignment vs PTCs.................................................................25

Priority sector lending requirements is a major driver in the
Indian securitization market.............................................................28

Typical originators and investors in Indian securitizations ... 30

Investors in the Indian securitization market............................31

Asset classes prevalent in Indian securitizations.......................31

Drivers for securitization in India ................................................32

Historical Issuance Volumes..............................................................34

Regulatory framework for securitisation in India ......................37

Securitization Regulations by RBI..................................................37

SEBI’ Regulations pertaining to securitization............................39

NHB’s Regulations...........................................................................41

Assignment of receivables in financing transactions: Truly a sale or
funding in disguise? ............................................................................44

Introduction .........................................................................................44

Bankruptcy Remoteness ..................................................................45

Is true sale a regulatory requirement? .........................................46

True sale and tax issues .................................................................47

True sale and accounting off-balance sheet...............................47

Disguised funding transaction: the banana skin ......................48

Re-characterisation risk in assignment of receivables ..........49

Basic tests in determining a true sale ..........................................50
List of figures

Figure 1: Securitisation transactions estimates over the years 13
Figure 2: ABS vs MBS 15
Figure 3: PTCs vs Direct Assignment 15
Figure 4: Country-wise fresh issuances in 2018 16
Figure 5: Historical Securitization Issuance 113
Figure 6: Percentage share by volume in 2018 114
Figure 7: No. of Deals vs Deal Values 115
Figure 8: Worldwide ABS issuance 115
Figure 9: Share of Asset classes in U.S. 119
Figure 10: CLO Issuance in the last 15 months (in USD Billion) 119
Figure 11: US Securitisation Issuance 120
Figure 12: Issuance in 2018 121
Figure 13: Volumes by Asset Class (2018) 122
Figure 14: Volumes by Asset Classes 123
Figure 15: China’s Structured Finance Issuance 124
Figure 16: Canadian Structure Finance Issuance 125
State of securitisation in India

Securitization volumes in India reach record high in 2019
Up, Up & Above!

The year that went for Indian securitization market was certainly a year to rejoice. Starting from the volume of transactions to innovative structures, new issuers, new investors and new assets, the market had everything to talk about. Traditionally, securitisation market in India has been acting as integrator of NBFCs with the banks and asset management companies. Surely enough, it was not an easy year for NBFCs. Yet, securitisation volumes scaled new peaks, as investors saw a safer harbour in securitisation and assignment structures rather than direct exposures on NBFCs. The fact that securitisation clocks best growth in years of stress is not unique to India – this has been seen in the past in several global markets too.

Before we discuss each of these at length, let us start with some highlights:

- Securitization volumes doubled during the year, as securitization in India became a trillion rupee market.
- DAs continued to be the preferred mode of transaction. Among asset classes, mortgage-backed loans was an important asset class, though mostly consisting of receivables generated out of loans against properties (LAP) lending.
- Clarity on Goods & Services Tax was one of the several factors that saw increased participation of private banks, NBFCs and mutual funds along with healthy demand for non-priority sector loans.
- Most NBFCs rushed to securitize as traditional sources of funding dried up due to concerns of debt servicing, due to failure of a leading NBFC of yester-years, and concerns as to build up of liquidity strains in case of some HFCs. These concerns, which started in the second half of 2018, continued through the financial year and have not quite subsided still.
- The country witnessed the first issuance of what is described as a covered bond. Irrespective of what the particular transaction does in terms of structure, or intent it tries to achieve, what is important is that the market does not lack of regulatory clarity as the pretext for not taking off on covered bonds.
Several new structures were tried, namely, lease receivables securitization, corporate loan securitization, revolving structures etc.

Securitization volumes reaching all time high
The volume of securitization grew by 123% as figures soared to ₹1.9 lakh crore in fiscal’ 19 compared to ₹85,000 crore in fiscal ’18. Mortgages, vehicle loans and microfinance loans constituted the three major asset classes comprising of 84% of the total volume.

The growth was primarily propelled by a combination of three factors.

First, a few big players who stayed away from the market returned after the GST Council clarified that securitized assets are not subject to GST.

Second, non-banking companies rushed to securitize their receivables as traditional sources of financing dried up after September 2018. This was the aftermath of the failure of a leading NBFC, and concerns about liquidity strain in some of the HFCs. After this, banks started preferring portfolio buyouts over taking credit exposure on the NBFCs. This was also assisted by a sensitized regulator.

As a temporary measure, the Reserve Bank of India (RBI) relaxed guidelines of minimum holding period requirement for securitization transactions backed by long duration loans leading to larger number of eligible securitized assets.

Third, in a year where banks were still reeling under NPA crisis and credit offtake by way of new bank lending was limited, acquisition of pools from NBFCs seemed to be the way to achieve credit growth.

The graph below shows the performance of the Indian securitization market over the years:

![Graph of securitization volumes over the years](https://www.crisil.com/content/dam/crisil/pr/press-release/2017/12/retail-securitization-volume-doubles-to-rs-1point9-lakh-crore.pdf)
Traditionally the bulk of securitization transactions have been driven by Priority Sector Lending (PSL) from banks. At present though, securitization transactions backed by non-PSL assets are making their presence felt as they gain market traction. The trend has been clear. The share of non-PSL assets as a part of total transaction rose to a record of 42% in 2018, up from 33% in 2017 and a relatively moderate share of 26% in 2016. Banks are focusing on securing long term assets such as mortgages that have displayed fairly stable asset quality to expand their retail asset portfolio.

The case for PSLCs
An additional recurring theme is the growing popularity in PSLCs which serves as a direct alternative to securitization. The volume of PSLC transactions has skyrocketed to ₹ 3.3 lakh crore in fiscal ‘19, up from ₹ 1.9 lakh crore in fiscal ‘18 and ₹ 49,000 crore in fiscal ‘17. PSLCs which were introduced in 2015, was an idea which appeared in the report of a Dr. Raghu Ram Rajan led Committee- A Hundred Small Steps. Out of the four kinds of PSLCs, the PLSC- General and PSLC- Small and Marginal Farmers remain the highest traded segments. The supply side consists of private sector banks with excess PSL in the general PSLCs category and Regional Rural Banks in SFMF category.

PTCs vs. DAs
Another point of note is the increasing share of the direct assignments (DAs) in the securitization market. The move from PTCs to DA isn’t surprising, because DAs are closer to bank lending than investing in PTCs. The flight-to-safety by banks who felt insecure in direct balance sheet exposure on NBFCs landed them on taking assignment of loan books of NBFCs as the surrogate. While, for the originators, it is possible to explain the absence of credit enhancements and consequential capital relief as the reason for popularity of DAs, however, it was more an investor-driven growth than originator-led. The fact that the share of PTC transaction fell from 47% in fiscal ‘17 to 42% in fiscal ‘18 and further to 36% in fiscal ‘19 serves as a case in point. However, one hasn’t impeded the growth for the other. DA transactions soared a record 146%. Whereas PTCs soared 95% reaching a volume of ₹69,000 crore. Also, mortgages still remain the preferred asset class, accounting for almost 74% of DA volumes and 46% of total securitization volumes.
India on the Global Map

2018 was a landmark year for global securitization with over a trillion dollars’ worth of issue, as the memories of the 2008 crisis gradually fade into oblivion. The U.S has been the major player in the global market, issuing over half of the total transactions by volume. Europe recorded a surge in volume clocking $106 billion against $82 billion in 2017. In Asia, China both grew and remained the dominant player in Asia at $310 billion, followed by Japan at $58 billion. Elsewhere, issuance in Australia and Latin America declined. Some potential factors that could affect the global markets in the coming future include the Brexit uncertainty, market volatility, rising interest rates, renegotiations of existing trade
agreements and liquidity. Some of these are contentious issues, the effects of which could sustain beyond the near future.

The notable point is that India was nowhere to be seen in the world map of securitisation – the volumes in India are now quite close to those of Australia or Canada.

**Total Issuance in 2018 by Country**

<table>
<thead>
<tr>
<th>Country</th>
<th>Values in US$ Billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>531</td>
</tr>
<tr>
<td>Canada</td>
<td>24</td>
</tr>
<tr>
<td>China</td>
<td>292</td>
</tr>
<tr>
<td>Australia</td>
<td>23</td>
</tr>
<tr>
<td>Japan</td>
<td>55</td>
</tr>
<tr>
<td>India</td>
<td>21</td>
</tr>
</tbody>
</table>

Figure 4: Country-wise fresh issuances in 2018
Source: SP Global

### Conclusion

Heading into the next fiscal year, some of the tailwinds that propelled the market in fiscal 2019 are fading gradually. Pent-up supply following the implementation of the Goods and Services Tax (GST) has almost exhausted, the funding environment for non-banks has been steadily stabilizing and the relaxation on the minimum holding period will be only available till May 2019. The entry of a new segment of investors - NBFC treasuries, foreign portfolio investors, mutual funds and others such brought about differing risk appetites and return aspirations which paved the way for newer asset classes. The trend for education loan receivables and consumer durables loan receivables accelerated in fiscal 2019. Although, the overall volumes of these unconventional asset classes are relatively small at present, investor presence in these non-AAA rated papers is a good sign for the long term prospects of the securitization markets.

---

The current financial year may not see the kind of growth noted in FY 2019, but it certainly promises to be the year of innovation.

“The Indian securitization market in 2018 have attained several significant milestones: from significant growth in non-PSL volumes, to asset class diversity, to attracting new investor base, to innovative structures, the market seems ready to launch into a new trajectory.”, stated Mr. Vinod Kothari, Director at Vinod Kothari Consultants.

He added, “It is only in stressful times that securitization has shone globally-- the Indian financial sector has gone through some stress scenarios in the recent past, and securitization has been able to sustain the growth of the financial sector.”
Innovative structures in the Indian securitisation market

2018-19 has been the year of the innovations in the Indian market. Starting from the first instance of covered bonds to securitisation of project loans, the market has witnessed several new structures. This section of the report covers some of the innovative structures. The comments below are based on information that our analysts could gather from public domain. Also, the report is not intended to be a complete chronicle, nor have any standard criteria been used for selection of the transactions discussed here.

1. India – RE Opportunities Trust – Project Loans Securitisation

**Originator:** Dewan Housing Finance Corporation Limited (DHFL)

**Collateral:** Corporate Loan Receivables

**Highlight:** The pool consists of two corporate loans pertaining to ‘The Bombay Dyeing and Manufacturing Company Ltd.’ (BDMCL) & ‘SCAL Services Limited’ (SCAL). However, SCAL is a Mumbai based company engaged in Real Estate, which is owned by BDMCL and its other group of companies.

**Total Deal Volume:** Rs. 1700 Crs. (inclusive of junior tranche kept as collateral)

<table>
<thead>
<tr>
<th>Instruments</th>
<th>Principal Amount (In Rs. Crs.)</th>
<th>Maturity date</th>
<th>Rating (Brickwork Ratings)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Senior PTCs</td>
<td>1375</td>
<td>Nov. 2023</td>
<td>BBB+ (SO)</td>
</tr>
<tr>
<td>Junior PTCs</td>
<td>325</td>
<td></td>
<td>Unrated</td>
</tr>
</tbody>
</table>

Transaction structure:

Credit Enhancement:
1. Total pool principal- 1700 Cr.| Junior tranche amounting to Rs. 325 Cr. (19.12% of pool principal) provided as credit enhancement
2. Further an amount equivalent to one month’s interest of the total pool principal will be retained with designated Banks.

Key Features of the Transactions:
1. The loan bears concentration risk as the pool comprises of 2 underlying loans. The geographical concentration is also high as both the project loans are for construction of residential towers in Mumbai. The risks are partly offset due to the projects being close to completion and Mumbai being a prominent residential market.
2. SCAL has entered into multiple MoUs with BDMCL to purchase 188 flats to further sell it down and have paid an advance of 187 Cr. towards booking. Risk arises if the SCAL is unable to sell the units for which it has MoUs with BDMCL.

2. Ess Kay Fincorp Limited – Persistent Securitisation

Originator: Ess Kay Fincorp Limited

5https://www.icra.in/Rationale/ShowRationaleReport/?Id=76276
**Arranger:** Northern Arc Capital Limited

**Collateral:** Receivables from vehicle loans

**Highlight:** The PTCs are backed by receivables from a Rs. 38.55 crore pool of vehicle loans. This is India’s first vehicle loan backed securitisation transaction with replenishing structure

**Total Deal Volume:**

<table>
<thead>
<tr>
<th>Instruments</th>
<th>Principal Amount (In Rs. Crs.)</th>
<th>Rating (ICRA)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Series A1</td>
<td>33.54</td>
<td>AA- (SO)</td>
</tr>
<tr>
<td>Series A2</td>
<td>1.16</td>
<td>A- (SO)</td>
</tr>
</tbody>
</table>

**Transaction structure:**

Credit Enhancement:

1. The credit enhancements are in the form of – a) principal subordination, b) EIS and c) credit collateral.
2. The principal subordination for A1 series is 13% and A2 series is 10%.
3. The EIS support is to the extent of 16.1% for A1 series and 12.6% for A2 series.
4. There is a credit collateral of 5% of the pool principal amount.

**Key Features of the Transactions:**

1. The receivables from used vehicle contracts will be transferred to the SPV at “par”. Two tranche of PTCs will be issued, the first tranche received a rating of AA-(SO) and the second tranche received a rating of A-(SO).
2. The tenure of the transaction is divided into two parts – a) Replenishment phase and b) Amortisation phase. In the replenishment phase, the principal repayments from the underlying cashflows will be utilized to acquire fresh receivables and only interest will be paid to the investors. In the amortization phase, the investors will be paid both interest and principal.

Additionally, the transaction also provides for trigger events, which if triggered will result in replenishment phase coming to an end.

3. **Kogta Financial India Limited – Covered Bonds**

**Originator:** Kogta Financial India Limited  
**Arranger:** Northern Arc Capital Limited  
**Collateral:** Receivables from vehicle loans

**Highlight:** This is a dual recourse instrument that enables Issuers to issue NCDs which can be rated multiple notches higher than their base credit rating. The higher rating is achievable on account of the comfort available from a combination of recourse to the issuer’s balance sheet and a ring-fenced pool of assets.

The ring-fenced pool of assets is assigned to a Special Purpose Vehicle which finances this purchase by issuing PTCs. Additionally, a First Loss Credit Enhancement (“FLCE”) or cash collateral may also be provided by the originator for the benefit of both NCD holders and PTC investors-the NCD holders have a priority on the FLCE over the PTC investors. An exclusive credit enhancement may also be provided for PTC holders alone.

**Total Deal Volume:**

<table>
<thead>
<tr>
<th>Instruments</th>
<th>Principal Amount (In Rs. Crs.)</th>
<th>Rating (ICRA)</th>
</tr>
</thead>
<tbody>
<tr>
<td>NCDs</td>
<td>25.00</td>
<td>AA- (SO)</td>
</tr>
<tr>
<td>PTC A1</td>
<td>25.73</td>
<td>BBB (SO)</td>
</tr>
</tbody>
</table>

[6] [https://www.icra.in/Rationale/ShowRationaleReport/?Id=76594](https://www.icra.in/Rationale/ShowRationaleReport/?Id=76594)
Transaction structure:

1. The Issuer issued NCDs to the Investors, with security on the Cover Pool assets, created in favour of debenture trustee. The same is over-collateralized.
2. The Cover Pool assets are then assigned to the SPV, which finances the transaction by issuing PTCs. The same is over-collateralized.
3. The beneficial interest of the PTC investors on the Trust Assets (i.e. cover pool receivables and the cash collateral) shall be subordinated to the security interest of the DT.
4. The amortization pattern of both the instruments shall mirror the pool amortization structure.
5. The primary obligation of the servicing the NCD holders is on the Issuer.
6. Till the time, the Issuer meets the obligations, the SPV will use the cashflows from the Cover Pool Assets to service the PTC holders. The moment, there is a default in payment by the Issuer, the Cover Pool assets shall be used for the meeting the same.

4. OPC Asset Solutions Private Limited – Lease rental securitization

Originator: OPC Asset Solutions Private Limited

Collateral: Lease receivables

7https://www.icra.in/Rationale/ShowRationaleReport/?Id=69317
**Highlight:** This was India’s first equipment lease rental securitization.

**Total Deal Volume:** Rs. 5000 Crores

<table>
<thead>
<tr>
<th>No. of Tranches</th>
<th>Instrument</th>
<th>Issue Size</th>
<th>Ratings (ICRA Ltd.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>PTCs</td>
<td>5000</td>
<td>AAA (SO)</td>
</tr>
</tbody>
</table>

**Transaction Structure:**

1. The cash flow considered here are rentals including the GST component and the discounting of these cash flows has been done at the PTC yield rate.
2. There will be ten days lag between the lease rental due date and the corresponding PTC pay out date.
3. This is the first instance of operating lease receivables securitisation in India.

**Credit Enhancement:** No

**Key Features of the Transactions:**
Indian Securitisation Market: A primer

Securitization as a financial instrument has been in existence in India from the early 1990s. Despite being in existence for nearly three decades, securitization market in India continues to be in its nascent stages. The securitization market in India has had several regulatory and taxation concerns in the past which have impacted the securitization volumes which have had lesser impact from external shocks or opportunities.

Securitization in India is in several ways very different from the rest of the economies:

1. Securitization Act: The first impulse on the part of anyone who is not insider to Indian securitization is to open the SARFAESI Act (Securitization and Asset Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002), as if to see the law of securitization in India. The confusion is so rampant that even Supreme Court rulings (with greatest respect) dealing with SARFAESI matters have strayed into Basel norms on securitization! As to how the SARFAESI Act contains “securitization” as a part its long name is a matter of historical curiosity, but none of the securitization transactions in India are structured under the SARFAESI Act.

2. Securitization includes bilateral loan portfolio sales: Another matter of surprise to many outsiders is that volumes of securitization in India include the so-called “direct assignments” (DAs), which are actually bilateral portfolio sales. However, the so-called DAs in India are not loan sales, as the transactions emerged as alternative to securitizations, and since the motivations and broad structures of these transactions are largely similar to securitization, the market tends to include DAs also as securitization”. The fact that there is no “security” created, and hence, literally, no securitization, does not seem to matter.

3. For several years in the past, a major driver for securitization in India was the priority-sector lending requirements of the RBI. These requirements, based on the holy objective of financial inclusion, require banks to have a certain exposure in “priority sector loans” (PSLs), which is fixed as a proportion of their net banking credit. Banks which do not have requisite branching network or
geographical outreach mostly fail to achieve these targets. The regulations permit that the bank that fails the PSL requirements may fill the same by buying other PSL-eligible portfolios, or even buying pass-through-certificates backed by PSL portfolios. As a result, lot of securitization activity was propelled by the PSL shortfalls. Recently, there are some alternative instruments which meet PSL shortfalls, and as a result, PSL-driven securitization has been on the decline recently.

It is worthwhile to mention here, that while asset-backed securities in the rest of the world are denoted based on the underlying assets they represent (for instance, residential mortgage backed securities, commercial asset backed securities, asset backed commercial paper and so on), in India, the securitized paper was called pass-through certificates or PTCs as they represented beneficial interest in the receivables. Therefore the securitization structure is often referred to as PTCs route in India as well. The first set of guidelines for securitization of standard assets was issued by RBI in February 2006\(^8\).

The issuance of these guidelines was subsequent to the market witnessing some seasoning on securitization transactions. The guidelines were the first attempt to regulate the securitization transactions. The regulations focused largely on securitization transactions using the special purpose vehicle, however direct assignments were not regulated by RBI then. The regulatory arbitrage prompted market to have an inclination towards doing more of bilateral assignments than securitization. However, the RBI issued the 2012 Guidelines\(^9\) which also covered prudential treatment of transfer of assets through direct assignment of cash flows and the underlying securities, if any. The revised 2012 Guidelines were not comprehensive in nature, dealing with limited issues like minimum retention requirements and minimum holding period, and as such were value additions to the existing 2006 Guidelines. Entities have to make a sensitive choice between direct assignments versus securitisation, weighing several different viewpoints.

**Direct Assignment vs PTCs**

\(^8\)https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=2723&Mode=0

\(^9\)https://rbidocs.rbi.org.in/rdocs/content/pdfs/FIGUSEO70512_I.pdf
Direct assignments resemble whole loan trades in other jurisdictions. Pass-through certificates include the familiar feature of a special-purpose vehicle that holds a deal’s assets and serves as the issuer of the deal’s securities.

The difference between direct assignments and pass through certificates have been tabulated below:

<table>
<thead>
<tr>
<th></th>
<th>PTC Securitization</th>
<th>Direct assignments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Legal format</strong></td>
<td>Assignment required</td>
<td>Assignment required</td>
</tr>
<tr>
<td><strong>True sale</strong></td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Transferability of a single loan</strong></td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Bankruptcy remoteness</strong></td>
<td>Yes, provided SPV does not get consolidated</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Special purpose vehicle</strong></td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Participation by multiple investors</strong></td>
<td>Yes</td>
<td>Yes, but as a joint ownership</td>
</tr>
<tr>
<td><strong>Nature of investment made by the investor</strong></td>
<td>Purchase of the securities of the SPV</td>
<td>Purchase of the underlying pool</td>
</tr>
<tr>
<td><strong>MHP</strong></td>
<td>Applies</td>
<td>Applies</td>
</tr>
<tr>
<td><strong>Risk retention</strong></td>
<td>Usually by credit enhancement</td>
<td>Mandatorily pari-passu</td>
</tr>
<tr>
<td><strong>Rating of the securities</strong></td>
<td>Usually uplifted, and may go up to AAA</td>
<td>No question, as investor buys a pool of loans</td>
</tr>
<tr>
<td><strong>Upfront encashment of profit</strong></td>
<td>Possible</td>
<td>Required</td>
</tr>
<tr>
<td><strong>Due diligence by investor</strong></td>
<td>Only based on the evaluation of the securities of SPV</td>
<td>Based on individual loans</td>
</tr>
<tr>
<td>PTC Securitization</td>
<td>Direct assignments</td>
<td></td>
</tr>
<tr>
<td>--------------------</td>
<td>--------------------</td>
<td></td>
</tr>
<tr>
<td><strong>Use of excess spread to meet losses</strong></td>
<td>Most commonly yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Servicing fee</strong></td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Subordination of servicing fee</strong></td>
<td>Not common</td>
<td>Yes, possible</td>
</tr>
<tr>
<td><strong>Cap on the extent of investment</strong></td>
<td>20%</td>
<td>No such cap</td>
</tr>
<tr>
<td><strong>Partial assignment</strong></td>
<td>Yes</td>
<td>Necessarily yes</td>
</tr>
<tr>
<td><strong>Exposure of the investor for concentration norms</strong></td>
<td>On the underlying loans</td>
<td>On underlying loans</td>
</tr>
<tr>
<td><strong>Accounting in the books of the investor</strong></td>
<td>Purchase of a security</td>
<td>Purchase of loans</td>
</tr>
<tr>
<td><strong>MTM requirements</strong></td>
<td>Applicable</td>
<td>Not applicable</td>
</tr>
<tr>
<td><strong>Capital relief</strong></td>
<td>Capital eaten up to the extent of first loss support</td>
<td>Full capital relief, as originator provides no credit enhancement</td>
</tr>
<tr>
<td><strong>Pricing</strong></td>
<td>Based on the rating of the resulting securities</td>
<td>May be worked out after considering losses and prepayments up to a certain level</td>
</tr>
<tr>
<td><strong>Liquidity from investor perspective</strong></td>
<td>Yes, the PTCs are transferable. The platform may allow other investors to buy PTCs being sold by an outgoing investor</td>
<td>No. Loans may be bought and resold but not very convenient</td>
</tr>
<tr>
<td><strong>Conversion into a standard marketable denomination, say Rs 1 lac per unit</strong></td>
<td>Possible and very common</td>
<td>Not possible. The whole loan has to be transferred</td>
</tr>
<tr>
<td><strong>Simplicity</strong></td>
<td>Not usually very simple to execute</td>
<td>Very simple to execute</td>
</tr>
</tbody>
</table>
Priority sector lending requirements is a major driver in the Indian securitization market

The role of regulation in shaping the market is critical. The Indian securitization market is largely driven by the need to meet the priority sector targets for banks; therefore, the dependence on demand for priority sector loans is great. Priority sector lending targets are specific requirements laid down by the RBI, which require banking institutions to provide a specified portion of their total lending to a few specific sectors. Banks in India are required to direct at least 40%, including foreign banks having more than or equal to 20 branches) of their total credit to certain sectors categorized as priority sectors:

<table>
<thead>
<tr>
<th></th>
<th>PTC Securitization</th>
<th>Direct assignments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax issues</strong></td>
<td>Tax issues currently faced on taxation of SPVs</td>
<td>No tax issues at all, as direct transfer of the asset</td>
</tr>
<tr>
<td><strong>Tax deduction at source by the borrower</strong></td>
<td>Does not apply</td>
<td>Applies</td>
</tr>
<tr>
<td><strong>Distribution tax</strong></td>
<td>Applies, up to 1st June 2016</td>
<td>Does not apply</td>
</tr>
<tr>
<td><strong>Off balance sheet treatment</strong></td>
<td>Yes, subject to conditions</td>
<td>Yes, subject to conditions</td>
</tr>
<tr>
<td><strong>Credit Enhancement</strong></td>
<td>Allowed</td>
<td>Not Allowed</td>
</tr>
</tbody>
</table>

Table 1: Direct Assignment vs Securitisation
Ambiguities with respect to the tax pass-through treatment of securitization transactions have been an obstacle to the market’s growth. In the past, investors in the Indian securitization market were mostly banks looking for assets in the designated priority sectors. Most Indian securitization transactions are tailor-made to suit individual investors’ need. Credit enhancement levels have been quite high and structures have been relatively simple. Also, the majority of the transactions do not distinguish between credit and liquidity support.

A distinguishing feature of securitization in India is that, although market participants view securitization as a means of access to the Indian capital markets, most of the instruments issued in Indian securitization transactions are unlisted and therefore do not actually facilitate access to India’s securities markets.

Table below shows selected milestones in the development of the Indian securitization market.
Typical originators and investors in Indian securitizations

The typical originators of securitization transactions include banks, non-banking financial companies (NBFC), housing finance companies, and microfinance companies. Priority sector lending requirements are a key motivation for Indian banks to invest in securitizations. Capital relief and portfolio liquidity are additional motivations for banks (and other potential investors) to invest in securitizations.

The investor base in the Indian securitization market is currently very concentrated. It is important to expand the investor base so that securitization serves more purposes than merely satisfying priority sector lending requirements. Investment in Indian PTC securitizations is limited to banks, NBFCs, and mutual funds. The Income Tax Department of the Ministry of Finance asserted that mutual fund investments in PTC securitizations produced revenue leakage. This caused mutual funds to avoid PTC securitizations. The issues relating to investments by mutual funds were resolved by the Finance Act 2013, but mutual funds have yet to return to the PTC securitization market as investors.
Investors in the Indian securitization market

- Banks
- NBFCs
- Mutual Funds
- FPIs
- Insurance Companies
- Pension Funds

Asset classes prevalent in Indian securitizations

Typically, any asset that produces a predictable stream of cash flows can be securitized. Throughout the 1990s, securitization of auto loans remained the centerpiece. Since then, several asset classes have been introduced to the market, including housing loans, corporate loans, commercial mortgage receivables, future flow receivables, project receivables, and toll revenues. The major asset classes prevalent in Indian securitization can be grouped as follows:

- **Mortgage loans**
  - Residential mortgage loans
  - Commercial mortgage loans
  - Commercial vehicle loans
  - Micro loans
  - Car loans
  - Construction equipment loans
  - Credit card receivables
  - Toll receivables
  - Gold loans

- **Retail loan pools**
Drivers for securitization in India

Both originators and investors have strong motivations for participating in the Indian securitization market. As noted previously, compliance with priority sector lending targets has been the strongest driver for banks to invest in Indian securitizations. Banks can make up any deficit in their own generation of priority sector loans by purchasing portfolios of such loans from NBFCs. Nonetheless, there is more to the Indian securitization market than just the priority sector lending targets. The full range of factors that drive market participation is much broader.

Originators’ incentives

The major originators of Indian securitization transactions are banks and financial intermediaries. Their primary motives for originating transactions include capital relief, profit stripping, and liquidity.

Capital relief

For highly leveraged banks, NBFCs, and microfinance entities, capital relief is a key incentive. However, it is clearly not the only one. If capital relief were the only motivation, synthetic securitization would have been a better solution. However, synthetic securitization has not yet emerged in India.

Increased leverage

In some of the securitization transactions—including ones backed by gold loans, loans against properties, micro-finance receivables, and personal loans—the originator’s primary motive is economic leverage. Securitization can allow an originator to achieve greater leverage than it could by using only on-balance-sheet debt.

Asset–liability management

Securitization enhances an originator’s asset–liability management (ALM). Most securitization structures provide perfect or nearly perfect ALM by having a direct link between the cash flows on the underlying assets and the cash flows on the issued securities.

Cost efficiency

Funding via securitization is usually less expensive than issuing corporate debt or borrowing from banks. Many securitizations carry high credit ratings and pay lower interest rates than the rates that an originator would have to pay on straight bonds or bank loans.
Alternative funding source

Securitization can provide an originator with a source of funding apart from the funding available by issuing traditional debt and equity securities. The originator’s liquidity is improved by having access to securitization as a funding source.

Managing portfolio risk

An originator can use securitization to manage different dimensions of risk in its asset portfolio. It can use securitization to rebalance or redistribute such risks as credit, market, and liquidity risks by selectively divesting certain assets. It can address diversification by using securitization to reduce concentrated exposures to certain asset classes.

Investor’s incentives

Insurance companies, mutual funds, and banks are the main investors in Indian securitizations. Strong credit ratings (often at the AAA level) combined with attractive spreads draw life insurance companies to the sector. Prepayment risk is important to life insurance companies because they have long investment horizons and need to match projected liabilities over the long term. Some securitizations have been structured to reduce prepayment risk, which makes them more appealing to life insurance companies and other investors with similar objectives. This has helped life companies to become a significant portion of the Indian securitization investor base.

The selection of “route”—DA or PTC securitization—usually depends on investors’ preferences. Deals are often customized to meet the investors’ requirements. For example, although mutual funds can invest only in “instruments,” banks ordinarily prefer to obtain loan portfolios outright. One reason for banks’ preference for DA securitizations is that loans (which are directly assigned in a DA securitization) are not subject to mark-to-market rules, while securities (which are issued in a PTC securitization) are subject to such rules.

Additional factors that motivate investors to invest in securitizations include the following:

- The flexibility of securitization instruments serves various investment objectives
- Investment is in highly rated structured finance products.
- Securitization provides better security to the investors, because they have a direct claim over the portfolio of assets.
- Availability of fixed-income securities in medium-term and long-term instruments
- Diversification of the investment portfolio.
- Rating stability—securitization investment is considered to have less credit volatility than corporate debt

**Historical Issuance Volumes**

Regulatory changes and tax issues have been key factors driving the fluctuating volume of securitization issuance in India. Table below shows the fluctuating volumes and the breakdown across certain major subsectors over the past five years. The dynamics of the subsectors and their respective activity levels have changed over time. For example, as shown in Table below, loan sell-offs (LSOs) have become extinct today. The regulatory directives from the RBI did not include LSOs, and so these were out of favor in 2010–2011. The loans were typically short term in nature, and an originator would disburse a loan with the intent to securitize it soon after the disbursement. LSO activity levels were reduced by the introduction of minimum holding period requirements in the RBI Guidelines on Securitization in 2012. This, along with the drop in demand from mutual funds in making investments in LSOs, ultimately eliminated the LSO market entirely.

The RBI’s release of the priority sector lending requirements in July 2011 triggered a shift in activity toward the asset classes covering the designated priority sectors. Additionally, bilateral deals in DA securitization format increased after the release of those requirements and grew to account for 75% of ABS and RMBS volumes in India. Before the release of the priority sector lending requirements, commercial vehicle loans and construction equipment loans had been the dominant asset classes.

The RBI’s update to the securitization guidelines in 2012 had a further impact on the markets. The update covered both DA securitizations and PTC securitizations. After a brief pause in activity, the market adapted to the updated guidelines, and securitization deals continued to take place. The updated guidelines encouraged the use of the PTC securitization structure because they prohibited credit enhancement in the DA structure.

However, 2012 was also the year that tax issues emerged, creating obstacles for securitization activity. Tax officials expressed the view that SPVs should be subject to a minimum marginal tax rate, thereby threatening the economic efficiency of PTC securitizations. The new tax
regime for PTC securitization transactions became effective for the 2013–2014 fiscal year. It produced an unfavorable impact on the post-tax yields of banks, which in turn depressed PTC securitization issuance activity. The market shifted back to favoring bilateral transactions in the DA securitization format. The following year brought a 150% increase in the issuance of DA securitization transactions.

Fiscal year 2013–2014 brought a modest recovery in the level of RMBS issuance activity. Both private sector banks and public sector banks were drawn to the sector as investors, seemingly without regard to incentives for priority sector lending targets. The tax uncertainties about revenue leakage from mutual fund investments in PTC securitizations were resolved in 2013, but the funds remained edgy about making investments in PTCs.

Furthermore, in May 2013, the RBI increased the exposure limits for agricultural and micro/small/medium enterprise (MSME) sectors. This enabled many banks to achieve greater priority sector lending volumes through their own loan originations and reduced their dependence on purchasing securitizations from third parties (often NBFCs) for meeting their priority sector lending requirements. However, priority sector assets—either loans or securities backed by priority sector loans—tend have low yields and can depress a bank’s after-tax returns. This creates an incentive for banks to invest in securitizations backed by no priority sector assets in order to achieve balance sheet growth with higher returns. It remains to be seen whether this will have an enduring impact on the industry in the long run.

The bottom line is that the flow of regulatory and tax changes has created a tumultuous environment for the Indian securitization market over the past several years. The changes have unsettled market participants and disrupted the orderly evolution of the market. For better or worse, the regulatory and tax changes have altered the market’s future course. Regulators have consistently intended to promote securitization as a beneficial financial technology within the context of the country’s growing capital markets. However, their actions have not always carried out their intent. Unfortunately, the recent wave of regulatory and tax changes may have done more to impede market development than to support it.

The recent actions of the government suggest that they are looking forward to make an environment that will facilitate the growth of securitization in India. A lot of credit must be extended to the Indian
Securitization Foundation\textsuperscript{10}, which has played an important role in helping regulators identify the problems in the market.

\textsuperscript{10} www.indiansecuritisation.com
Regulatory framework for securitisation in India

Securitization Regulations by RBI

As mentioned earlier, India has specific guidelines on securitization issued for banks and NBFCs by RBI. The first set of guidelines were issued in 2006 (2006 Guidelines) and these guidelines were revised in 2012. RBI issued the revised guidelines for banks in May 2012\(^1\) and for NBFCs in August, 2012\(^2\) (2012 Guidelines).

The 2012 Guidelines were in addition to the existing 2006 Guidelines, this is to say, both the guidelines were to be read in consonance. The 2012 Guidelines was divided into 3 parts. Part A contained provisions on PTCs route securitization, Part B contained provisions on DA and Part C contains provisions on securitization exposures that are not permitted under law.

A brief highlights on the 2012 Guidelines is as below:

- **Homogenous assets:** The 2012 Guidelines make a reference to homogenous assets and though not defined, the expression homogenous assets would mean all such assets that share similar risk attributes would be called homogenous assets.

- **Assets eligible for securitization:** The 2012 Guidelines talk about securitization of performing loans. Securitization of non-performing loans is covered by separate guidelines. The pool of loans securitized should be homogenous in nature.

- **Assets not eligible for securitization:** Under the 2012 Guidelines the following are not eligible assets for securitization:

  - Single loans;
  - Revolving credit facilities;
  - Assets purchased from other entities;
  - Loans with bullet repayment of principal and interest.

- **MHP requirements:** The 2012 Guidelines require the loans to be seasoned in the books of the originator for some minimum time before they can be securitized. The intent is to ensure that the entire risk is not passed to the investors and during the seasoning period the portfolio would have demonstrated repayment performance to ensure better underwriting standards. MHP shall be counted from

---

1. [https://rbidocs.rbi.org.in/rdocs/content/pdfs/FIGUSED70512_I.pdf](https://rbidocs.rbi.org.in/rdocs/content/pdfs/FIGUSED70512_I.pdf)
the date of full disbursement of loans for an activity/purpose; acquisition of asset by the borrower or the date of completion of a project. MHP requirements apply to individual loans, neither to borrower nor to the pool and runs from the date of disbursement to the purchase of the assets. So all loans in the pool that do not comply with the MHP requirements will have to be filtered out before the pool can be securitized.

- **MRR requirement:** MRR requirements have been laid down to ensure that the originators have continuing stake in the securitized assets so that the investors’ interests are not compromised at any point of time. The 2012 Guidelines state that the MRR may also include a vertical tranche of securitized paper in addition to the equity/subordinate tranche... (emphasis ours). The principles on MRR as laid down in the 2012 Guidelines are that the first loss support must necessarily come from the originator and the equity tranche must be held by the originator at least up to MRR. However, the required MRR, which may be more than the needed first loss piece, need not be an equity tranche or horizontal tranche. This gives the originator the flexibility to invest in a combination of vertical and horizontal piece, which is called the L-shaped structure. The first loss piece as per the Final Guidelines shall include all forms of originator support except for IO strips and MRR shall be percentage of principal value. The 2012 Guidelines also make it clear that the MRR shall not remain constant over the term of the transaction, it shall amortize over the period. In case of direct assignments the MRR should rank pari-passu with the sold portion of the assets. There is no credit enhancement permitted in case of direct assignments at all.

- **Total Retained Exposure:** The 2012 Guidelines make reference to the Basel II norms to state that the total investment by the originator in the securities issued cannot exceed 20% of the total securitized instruments issued. If the banks exceed the limit, the risk weight of 1111% shall be applicable on the excess amount of exposure.

- **Profit recognition and off balance sheet treatment:** The 2012 Guidelines require upfront recognition of cash profits only. The unrealized profits includes IO Strips need to be amortized over a period of time. In case of direct assignments, the profit recognition requirements are the same.

- **Third party credit enhancements:** In case of direct assignments even a third party can provide credit enhancements. This would bring down the cost for the originators and increase the capital relief.

The 2012 Guidelines also intended to resolve the ambiguity that was created by the 2006 Guidelines. The 2006 Guidelines left some
ambiguity on the possibility of reset of credit enhancements as and when the securitized instruments amortized. Owing to the ambiguity it was believed that the credit enhancements in securitization were to be maintained at the initial levels till the securitized paper was retired completely. Needless to say, the structures globally did not require any reset nor was it structurally efficient to do so. As and when the securitized paper amortized the credit enhancements as a percentage of the outstanding securities increased. In 2012, RBI clarified on the issue and set guidelines\(^\text{13}\) with regard to reset of credit enhancements\(^\text{14}\).

SEBI’ Regulations pertaining to securitization

Securities Exchange Board of India (SEBI) came out with the Securities Exchange Board of India (Public Offering and Listing of Securitized Debt Instruments) Regulations, 2008\(^\text{15}\) with regard to making a public offer or listing of the securitized debt instruments. The regulations states that the securitized debt instruments cannot be listed or offered to public by any person, unless it is constituted as a special purpose vehicle, complies with the provisions of the regulations and has all its trustees registered with SEBI.

Assignment of debt or receivables:

Regulation 10 states the conditions that need to be fulfilled with regard to assignment or true sale of debt or receivables to the special purpose distinct entity and it being a legally realizable assignment for the purpose of securitization. The debt or receivables assigned to the special purpose distinct entity identifiable stream of cash flows for servicing securitized debt instruments that free from encumbrances and set-off and the originator has valid enforceable interest on the assets prior to securitization. Further the assignment of the debt or receivables happens at arm’s length for commercial consideration and originator obtained all necessary regulatory and contractual consents for such assignment and adheres to all representations and warranties with regard to receivables. The intent of assignment of debt or receivables to a separate special purpose distinct entity is to minimise the risk of these receivables or debt so assigned (asset pool) being consolidated with the assets of the originator or sponsor in the event of winding up or insolvency of either of them.

\(^{13}\)https://www.rbi.org.in/scripts/NotificationUser.aspx?id=8149&Mode=0
\(^{14}\) See our article explaining the provisions of reset of credit enhancements by Nidhi Bothra here: https://www.indiafinancing.com/Reset_of_credit_enhancement_guidelines_for_securitization_transactions.pdf
\(^{15}\) http://www.sebi.gov.in/acts/sdreg.pdf
Schemes of special purpose distinct entity

The special purpose distinct entity may raise funds by making an offer of securitized debt instruments by launching one scheme or multiple schemes and the trustees shall ensure that the realisation of the receivables are used appropriately for the redemption of the securitized debt instruments. The terms of issuance may also have an option for clean-up call. The schemes shall be wound up a) on full redemption of the securitized debt instruments, b) attaining legal maturity as stated in the terms of issuance and c) vote of investors by special resolution for the winding up of the scheme.

Credit enhancement and Liquidity facility

The terms of issuance or the offer document would state clearly about the credit enhancements of the asset pool and the liquidity facility availed and full disclosures need to be made in the offer document or particulars submitted to the stock exchange.

Holding of the originator

Subject to originator acquiring securitized debt instruments on account of underwriting of public issue or credit enhancement arrangement and appropriate disclosures made in the offer document in this regard, Regulation 19 restricts the holding of the originator in the securitized debt instrument to not more than 20% of the total securitized debt instruments issued in a scheme that shall be offered to public or listed.

Offer to Public

The securitized debt instruments may be offered to public at large or any particular section of the public. Any offer made to fifty or more persons in a financial year shall be deemed to be made to public. The regulations also clarify that an offer shall not be considered to be public offer, if, a) it is unlikely that directly or indirectly, the securitized debt instruments shall become available for subscription or purchase by persons other than those receiving the offer and b) it is a domestic concern of the persons making or receiving the offer.

Mandatory listing and rating for securitized debt instruments

Where an offer of securitized debt instruments is made to public the special purpose distinct entity shall make an application for listing to one or more recognised stock exchanges and shall obtain credit rating for the securitized debt instruments from atleast two registered credit rating agencies and all such ratings obtained with regard to the securitized debt instruments shall be disclosed in the offer document including unaccepted credit ratings. The regulations states the role of
the trustees, originator, servicer, credit rating agencies and parties, rights of the investors, role of Board with regard to issuance of the securitized debt instrument, the modus operandi for issuance and disclosures made to that effect.

**NHB’s Regulations**

The RMBS segment is regulated by National Housing Bank (NHB), a wholly owned subsidiary of Reserve Bank of India and is mandated to regulate, supervise and provide financial support to the housing finance companies registered with NHB. The development of secondary mortgage market in India was dependent on the introduction of securitization and NHB played a critical role in evolving securitization transaction to gain acceptability in the market within the existing regulatory framework.

NHB provides for the securitization process, the primary lending institution is required to enter into an umbrella agreement (called Memorandum of Agreement) with NHB to sell/ securitise its portfolio of housing loans. The eligibility criteria set out by NHB for home loans to qualify for securitization are as below:

The home loans should satisfy the following standards for being considered for selection in the Mortgage Pool offered for securitization:

a. The borrower should be individual(s).

b. The home loans should be current at the time of selection/securitization.

c. The home loans should have a minimum seasoning of 12 months (excluding moratorium period).

d. The Maximum Loan to Value (LTV) Ratio permissible is 85%. Housing loans originally sanctioned with an LTV of more than 85% but where the present outstanding is within 85% of the value of the security, will be eligible.

e. The Maximum Instalment to (EMI) to Gross Income ratio permissible is 45%.

f. The loan should not have overdues outstanding for more than three months, at any time throughout the period of the loan.

g. The Quantum of Principal Outstanding Loan size should be in the range of Rs.0.50 lakh to Rs.100 lakhs.

h. The pool of housing loans may comprise of fixed and/or variable interest rates.

i. The Borrowers have only one loan contract with the Primary Lending Institution (PLI).

j. The loans should be free from any encumbrances/charge on the date of selection/securitization. The sole exception to this norm being loans refinanced by NHB.
k. The Loan Agreement in each of the individual housing loans, should have been duly executed and the security in respect thereof duly created by the borrower in favor of the PLI and all the documents should be legally valid and enforceable in accordance with the terms thereof.

I. The Bank/HFC has with respect to each of the housing loans valid and enforceable mortgage in the land/building/dwelling unit securing such housing loan and have full and absolute right to transfer and assign the same to NHB.

The transactions are typically such that the originator, servicer and loan administrator is an HFC or bank, NHB sets up the special purpose vehicle (SPV) and acts as a trustee to the transaction.

The HFC/bank assigns the retail housing loan pool to NHB SPV and the SPV in turn issues certificates called Pass through certificates (PTCs) to the investors that are institutional investors including Insurance Companies, Mutual Funds, Financial Institutions, and Commercial Banks. The PTCs are in the nature of trust certificates and represent proportionate undivided beneficial interest in the pool of housing loans. PTCs again are issued in tranches of Class A and Class B. While Class A tranche PTCs are subscribed by the investors, Class B, the subordinated class is retained by the originator as the first loss piece, which means it acts like a credit enhancement for Class A investors to attain AAA rating.

NHB placed its first mortgage backed securitization transaction before the capital markets in 2000 and has so far launched ten issues of RMBS with total loan size of Rs.665 crore\(^1\)\(^6\).

RMBS was a major asset class in early years of securitization. It almost completely disappeared in 2007 and 2008. In 2009 and 2010, there seems to be a revival of the RMBS market. Reasons for absence of RMBS transactions are very difficult to understand, except that the mortgage market is dominated partly by banks and partly by a few large housing finance companies. RMBS issuances have a very narrow base of investors and originators. Banks do not have reasons to sell their housing loan portfolios; larger mortgage originators have significant liquidity alternatives, and therefore, may not have the motivation to securitize. RMBS had been on a low key till 2011 and the market composition in terms of number of originators remained highly skewed in this segment; in the financial year 2013-14 however, the number of

\(^{16}\) Last visited on 19th May, 2018
RMBS transactions tripled to 30 in numbers from 10 in 2012-13 while the average deal size became smaller.
Assignment of receivables in financing transactions: Truly a sale or funding in disguise?

Introduction

In legal interpretation, whether a document, manifestly reading like a transfer agreement, has the true effect of transferring an asset or merely leading to a disguised funding transaction, is always a matter of dispute before Courts. Everything is fine in good times, but the so-called sale was documented to be of help during financial distress or bankruptcy; so in distress or bankruptcy, questions are raised as to whether the purported sale is a sale or financing transaction. A number of so-called “sales” may be really garbed funding transactions, in which case a Court may re-characterise such transactions as funding transactions. If the transaction is treated as a financing transaction, the very purpose that the sale documentation tried to achieve will be frustrated. Worse still, the transaction may be regarded as unsecured funding, since security documentation may not have been done.

The question of “true sale” is, therefore, a question as to whether a documented sale will be regarded as truly achieving the objective of a sale, and will be respected as such in bankruptcy or similar situation.

The question of true sale can arise in context of several financial transactions which are contended to be sale of a collateral or an asset. For example, in securitisation, the pool of receivables is sold, with a view to create a bankruptcy-remote structure. In direct assignments too, there is a sale of the single loan or portfolio of receivables. In case of a factoring transaction, the creditor contends to have sold the debt or the accounts receivables to the factoring company. Sometimes, in a securities ready forward transaction or securities repo transaction, the person who has the securities contends that he has sold the securities with an agreement to buy it back.

So, all of these transactions may inherently be driven by financing motive but they are structured as sale transactions. The motive is financing; however, the device used is selling. The question, therefore, is that if something is inspired with the overall intention of raising funding but the transaction adopts the mechanism of making a sale, then is the legal device of sale so clear and so defensible that the underlying intent therefor becomes irrelevant, or is it that the
underlying intent of the structure is so very overwhelming that the legal device is completely eclipsed by the intent. Thus, if the intent prevails, and looking at the intent or the substance, the transaction seems to be a financial transaction and not a sale transaction, the result is that a judicial authority disregards the form of the transaction and captures its substance.

What is the intent of parties, in financial transaction, to achieve the sale of the collateral? The intention is primarily to put the asset into the exclusive right of the so-called buyer or who is actually the financier in the transaction and therefore put the asset beyond the reach of the liquidator or creditor in the event of bankruptcy of the seller. The intent is to immunise the collateral from the risk of insolvency or bankruptcy administration. In bankruptcy laws, while security interest over an asset gives the secured creditor strong rights over the asset, however, the right is subject to pari passu rights\(^\text{17}\), and sometimes, even over-riding priorities\(^\text{18}\). In any case, the bankruptcy process causes a disruption in the payments to the financier, as the payments will now be subject to moratorium, bankruptcy administration, etc. On the other hand, if the financier has acquired legal rights over the asset, the same is free from any claim of a creditor or liquidator, and the asset will not form part of the liquidation estate.

**Bankruptcy Remoteness**

In most of the so called structured finance transactions, the objective is to achieve bankruptcy remoteness. Bankruptcy remoteness, in this context, means to structure the transaction such that even if the entity in question goes into bankruptcy, the liquidator or the creditors will not be able to reach out to the asset in question. For instance, if the transaction in question is securitization, the pool of assets has been “sold” to the SPV. Can the liquidator or the creditors question the sale and reclaim the ownership rights over the pool of assets and give priority to the so-called investors in a securitisation transaction only at par with other secured and unsecured lenders? In other words, if the sale is questioned and the transaction is treated as secured financing, or, if a security creation has not been done, the transaction may face a worse fate: -it may be treated as unsecured financing. From a so called sale that conveys absolute right to the acquirer, the transaction slips down to achieve a parity with secured financial transaction, or, worse still, it might even be read at par with unsecured lending transaction.

---

\(^\text{17}\) Such as those of workmen in many countries  
\(^\text{18}\) Such as those of statutory claims in some countries.
Consequently, the investors may be prone to risk of suffering substantial haircuts, which is a common feature of a deep insolvency.

This explains the significance of the “true sale” treatment.

Is true sale a regulatory requirement?

In India, securitisation or direct assignment transactions are guided by Guidelines on Securitisation and Direct Assignment\(^\text{19}\) issued by the Reserve Bank of India. As per the said Guidelines, the isolation of assets or ‘true sale’ from the originator to the SPV is an essential prerequisite. Further, an illustrative list of criteria for true-sale have been prescribed in the 2006 RBI Guidelines which is inclusive in nature. They are:

1. The selling Bank/ NBFC shall effectively transfer all risks / rewards and rights / obligations pertaining to the asset and shall not hold any beneficial interest in the asset after its sale except those specifically permitted under the guidelines.
2. The buyer shall have the unfettered right to pledge, sell, transfer or exchange or otherwise dispose of the assets free of any restraining condition.
3. The selling Bank/ NBFC shall not have any economic interest in the assets after its sale and the buyer shall have no recourse to the selling Bank/ NBFC for any expenses or losses except those specifically permitted under the said guidelines.
4. There shall be no obligation on the selling Bank/ NBFC to re-purchase or fund the repayment of the asset or any part of it or substitute assets held by the buyer or provide additional assets to the buyer at any time except those arising out of breach of warranties or representations made at the time of sale.
5. If the seller of loans acts as the servicing agent for the loans, it shall not detract from the ‘true sale’ nature of the transaction, provided such service obligations do not entail any residual credit risk on the sold assets or any additional liability for them beyond the contractual performance obligations in respect of such services.
6. Any re-schedulement, restructuring or re-negotiation of the terms of the underlying agreement/s effected after the transfer of assets to the buyer, shall be binding on the buyer and not on the selling Bank/ NBFC except to the extent of MRR.

\(^\text{19}\) Paragraph 102 of Master Direction for NBFC-ND-SI and paragraph 89 of Master Direction for NBFC-ND-NSI
**True sale and tax issues**

In case there is a legal transfer of property, being a true sale of the assets to be securitised, the gain/loss, if any, arising on the transfer shall be taxed in the hands of the originator.

The next question is the taxation of the SPV or the securitisation trust—whether the same will depend upon the true sale classification of the transfer?

As per the provisions of section 115TCA of Income Tax Act, 1961, any income accruing or arising to, or received by, a person, being an investor of a securitisation trust, out of investments made in the securitisation trust, shall be chargeable to income-tax in the same manner as if it were the income accruing or arising to, or received by, such person, had the investments by the securitisation trust been made directly by him. The income of the investors shall be subject to tax deduction at source at the time of distribution. Such income will taxable in the hands of the investors.

The section 115TCA was introduced with an intention to provide a tax pass through status to securitisation trusts. The section is a modified version of the sections 115TA, 115TB and 115TC. The older sections required securitisation SPVs to deduct securitisation distribution tax every time it distributed income to the investors at a flat rate.

The modified section 115TCA requires the securitisation SPVs to distribute the income to the investors, net off TDS. Since, the recipient of the income can claim credit of the tax deducted on source, against its tax liability, this offers a tax pass-through to the investors.

However, section 115TCA is applicable on such securitisation trusts that are treated as a “special purpose vehicle” defined in, and regulated by the Guidelines on Securitisation issued by the RBI. Any other securitisation trust outside the RBI framework are not be eligible for the pass through structure.

Therefore, only when the transaction satisfies all the conditions laid down in the RBI Guidelines, it will be treated as securitisation transaction, and the SPV will be treated as securitisation trust, for the purpose of section 115TCA. Legal true sale being an essential requirement under the RBI Guidelines, becomes quintessential for claim the tax pass-through status as well.

**True sale and accounting off-balance sheet**

Under the erstwhile Indian GAAP, there was no specific standards dealing with securitisation accounting or de-recognition. In absence of
specific directions, legal true sale was often considered to be the conclusive evidence for de-recognition.

India is set to align itself with IFRS in a phased manner over a period of time. The financial entities are required to adopt IND AS starting from the financial year 2018-19. Post IFRS convergence, the primary task would be to determine whether a transaction will qualify for de-recognition. Derecognise of a financial asset can happen only when the contractual rights to the cash flows from the financial asset expires or the entity transfers the financial asset and the transfer qualifies for derecognition in accordance with para 3.2.6.

Now, para 3.2.4 states that a financial asset can be transferred either by transferring the contractual rights to receive the cash flows of the financial asset, that is sale of the asset, or by retaining the contractual rights to receive the cash flows of the financial asset, but assuming a contractual obligation to pay the cash flows in an arrangement that meets the prescribed conditions. Here, the prescribed conditions obligates the transferor to remit all cash flows it collects on behalf of the eventual recipients without material delay, provided the obligation to pay arises only when it collects equivalent amounts from the original asset and prohibits the transferor to sell or pledge the original asset to any third party (para 3.2.5).

Hence, it can be inferred that for de-recognition of the financial asset, true sale is not an essential condition. Pass through arrangements or loan sub-participations may also result in the off-balance sheet treatment of the financial asset.

**Disguised funding transaction: the banana skin**

Why is that the parties in financial transactions discussed above are likely to be caught by the true sale question? Since, often, the parties who are transacting are basically financial entities, they are likely to construct the transaction with overwhelming features of a financing. The seller is a financial entity wanting to finance or refinance his business; the buyer is also mostly a financial entity, looking for a rate of return. This real intent may be so predominant that the parties fail to abide by the basic requisites of a sale transaction. Therefore, the so-called sale is very easily assailable as a financing transaction. History of factoring, securitisation and loan sale transactions is replete with instances where the truth of the sale has been questioned.

If these transactions are relatively new, traditionally, in English law, there have been innumerable instances where courts have tried to characterise a conveyance with an agreement of re-conveyance as a
mortgage by conditional sale\textsuperscript{20}, or a bill of sale as a chattel mortgage\textsuperscript{21}, or a sale as a loan.

Thus, the true purport of a make-believe sale has always been a part of judicial probe.

Re-characterisation risk in assignment of receivables

Our present write-up concerns assignment of receivables. Assignment is the method used in all securitisation and factoring transactions. The history of securitisation and of factoring transactions world over is full of cases where, primarily in the context of bankruptcy law, liquidator and bankruptcy administrators have questioned the truth of the sale, so as to bring back the so-called alienated assets, and add them to the liquidation estate for the benefit of the general creditors and stakeholders.

While there have been plenty of cases all across the world on true sales, the objective of studying such precedents is to try and assimilate if it is possible to construct a list of DOs and DONTs, to be of guidance in structuring transactions. However, the predicament is that the question is a subjective question. The subjectivity is very easily understandable because, after all, the parties have documented a sale to be a sale. Except in very badly done drafting job, every draftsman will use a basic sale language in the document. The court now examines the so called sale document to try and smell whether the sale is actually smelling like a financing transaction. So, the so-called smell test inherently becomes subjective and indecisive. It is very difficult to lay down a clear and precise set of rules or to draw a bright line that demarcates a true sale and a disguised financing. Since no case by itself is identical with another, every case has its unique set of facts, and after review of the facts and a catena of precedents, a court would, at the end of the day, either uphold the truth of the sale or deny it. In essence, parties don’t have a safe harbour. The situation can worsen in case the transaction involves a huge magnitude of money, and may often result into issuance of capital market securities, with a shifting investor base.

Nevertheless, going through past precedents, it is possible to lay down some tests, which might, if properly observed, still grant a reasonable certainty that the sale will be regarded as a true sale. Very often, in securitisation transactions in particular, it is common to go to a lawyer and obtain a true sale opinion. It may be important to appreciate that the mere existence of a favourable true sale opinion is no assurance by itself. After all, the true sale opinion is the opinion of a lawyer; if the

\textsuperscript{20} Poindexter v. McCannon, 16 N.C. 373, 18 Am.Dec. 591
\textsuperscript{21} Monongahela Ins. Co. v. Batson, 111 Ark. 167, 163 S.W. 510, 511
opinions of courts could differ, so does the opinion of the lawyers. Parties are advised to search their souls and ask whether they truly intended a sale with attendant risks and rewards of the collateral, or merely wanted to dress a loan as a sale.

Below, we discuss some tests that may assist in this soul-searching exercise.

**Basic tests in determining a true sale**

**Language of the agreement**

First and most important test is the language used: very often, courts have held that the intent of the document has to read from the language. There is no intent beyond the explicit language, unless circumstances warrant that the transaction itself was a sham and the parties were trying to write what they did not mean. There are rulings and rulings to suggest that the document has to be read according to its vivid language.

In *McEntire v Crossley Bros Ltd* [1895] AC 457 at 462-463 [1895-9] All ER Rep 829 at 831, it was held as follows:

‘... I quite concede that the agreement must be regarded as a whole – its substance must be looked at. The parties cannot, by the insertion of any mere words, defeat the effect of the transaction as appearing from the whole of the agreement into which they have entered. If the words in one part of it point in one direction and the words in another part in another direction, you must look at the agreement as a whole and see what its substantial effect is. But there is no such thing, as seems to have been argued here, as looking at the substance, apart from looking at the language which the parties have used. It is only by a study of the whole of the language that a substance can be ascertained.’

In *Orion Finance Ltd v Crown Financial Management Ltd* [1996] BCC 621, the UK court went to the extent of holding that if there were not clear indicators of a sham contract, generally the court will not be inclined to get into questions of intent. To ascertain that intention requires a careful balancing between the ‘language’ of contract provisions, on one hand, and their ‘legal effect’. If that effect is inconsistent with the language, language must yield.

---

22 A generic discussion on relevant case law on securitisation can be read here: [http://vinodkothari.com/seccases/](http://vinodkothari.com/seccases/)

23 [https://uk.practicallaw.thomsonreuters.com/D-000-4220?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk &bhcp=1](https://uk.practicallaw.thomsonreuters.com/D-000-4220?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk &bhcp=1)
In a Hong Kong ruling dealing with an assignment of receivables, after extensively reviewing the caselaw in USA and UK, in Incorporated v Yun Choy Limited and the Standard Chartered Bank (Hong Kong) Limited, [2012] 1 HKLRD 396, there were several factors which, taken together, might have hinted at the sale being actually a disguised financing transaction. However, the Court was inclined to hold that the best indicator of intent of the parties is the language chosen by the parties, and if the language was clear, and there was no hint of an intended fraud, there was no reason for the court to deviate from the language.

Having said as much about the significance of the language, it is also important to note that the language itself cannot be decisive. If the draftsmen is reasonably skilled, then every draftsman will use the assignment language. If language was the ultimate test, then numerous documents that actually read alike will never be questioned in terms of their intent. Language, as Justice Krishna Iyer mentioned, is a good guide to meaning, but a bad master to dictate.

Bonafide intention

One could have easily put the real intent of the parties as the foremost factor, because everything else flows from the intent. How to gather the intent? While the true sale question is all about intent, and intent is often elusive, the issue is – was there a motive for the parties to camouflage their intent. Parties at arms’ length, in commercially transparent transactions, are presumed to be intending what they write, unless there is an underlying motive to garb their actual intent and use the language merely to put the assets beyond the reach of the liquidators and creditors. Such a motive is easy to impute in cases where the buyer is concerned with seller’s default or bankruptcy risk. This does not necessarily imply that the seller may be nearing a default; however, the inspiration for the particular structure may have been a bankruptcy-remote rating, or otherwise provide to the buyer a ring-fenced claim over the collateral. The presence of such an intent will give the court sufficient motivation to track down for factors defying a true sale intent.

In England, the relevant elements to distinguishing a sale from a secured transaction were established long time back by Rome J in Re George Inglefield Ltd.

---

26 Rome J in Re George Inglefield Ltd 1933 Ch. 1
<table>
<thead>
<tr>
<th>Basis</th>
<th>True Sale</th>
<th>Mortgage</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Right to claw back the collateral</strong></td>
<td>Seller is not entitled to get back the asset sold by returning the money to the purchaser</td>
<td>Mortgagor is entitled, until he has been foreclosed, to get back the asset by returning the money to the mortgagee</td>
</tr>
<tr>
<td><strong>Right to receive surplus</strong></td>
<td>The purchaser does not have to account the seller of any profit realized by sale of the asset purchased from the seller. The purchaser cannot recover from the seller any amount which upon resale of the purchased property was insufficient to recoup the money paid to the seller</td>
<td>Any amount realized in excess of the amount sufficient to repay the mortgagee shall be accounted back to the mortgagor. A mortgagor is entitled to recover from the mortgagee the difference between the amount from sale of asset and the amount due from the mortgagor, if the amount from the sale of asset is insufficient to meet such amount due</td>
</tr>
<tr>
<td><strong>Right to receive the shortfall</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The decision emphasized the ‘risks and rewards’, rather than ‘control’ over the property.

In the case *Incorporated v Yun Choy Limited and the Standard Chartered Bank (Hong Kong) Limited*, [2012] 1 HKLRD 396, despite the numerous elements that kept the assets’ risk in the transferor’s hands, the court found that the transfer was a ‘sale’. It was held that the court will consider the legal rather than the economic substance of the arrangement when construing the factoring agreement. The Court was inclined to hold that the best indicator of intent of the parties is the language chosen by the parties. If the language was clear, and there was no intent of an intended fraud, there was no reason for the court to deviate from the language.

**Reversible transaction**

One of the important factors in true sale determination is the presence of an option or obligation of the seller to buy the collateral back. Typically, if the seller sells something and continues to retain the right of buying it back, the transaction takes the character of renting the asset rather than selling it. A sale, as in normal course, should put the assets irretrievably in the domain of the buyer. A sale with the seller’s right of clawback or buyback does not allow the buyer the liberty of reselling or pledging the assets, and hence, the sale does not appear to be absolute.

In a mortgage by conditional sale, there is a transfer of property, with the seller’s right of redeeming the property once the financing is repaid. A sale with an option to buyback may be close to a mortgage by conditional sale.

In addition to the emphasis on substance, regardless of the ‘label attached to the transaction’, the court indicated that ‘The root of all of these factors is the transfer of risk’. The court continued: ‘Where the lender has purchased the accounts receivable, the borrower’s debt is extinguished and the lender’s risk with regard to the performance of the accounts is direct, that is, the lender and not the borrower bears the risk of non-performance by the account debtor. If the lender holds only a security interest, however, the lender’s risk is derivative or secondary, that is, the borrower remains liable for the debt and bears the risk of non-payment by the account debtor, while the lender only bears the risk that the account debtor’s non-payment will leave the borrower unable to satisfy the loan.’

28 Buyer retains generic recourse to the seller

While recourse itself may not be destructive of true sale, a generic recourse back to the seller may give a strong indication that the parties intended a financing transaction.

Generic recourse means the seller has created a generic obligation to pay a fixed amount to the buyer, on fixed dates, irrespective of collections from the underlying asset. On the other hand, if the recourse is only due to breach of representations and warranties, or a limited credit recourse, it may still be consistent with true sale.

In the Welsh Development case, the Court had held a transaction to be sale even though the same apparently looked like a financing transaction but was documented as a sale. Factoring or block discounting amounts to a sale of book debts, rather than a charge on books debts, even though under the relevant agreement the purchaser of the debts is given recourse against the vendor. There may be a sale of book debts, and not a charge, even though the purchaser has recourse against the vendor.

As opposed to the above, in US courts, there have been several rulings where so-called sales have been held as financing transactions. Other
common law courts, such as those in Canada\textsuperscript{31}, have, like their English counterparts, adopted an approach focused on the parties’ intention.

In Major’s Furniture\textsuperscript{32}, it was held that courts are not subject to the parties’ nomenclature, the form of the contract, the name given to it by the parties or the form of words. The existence of recourse would not, in itself, suffice to classify the transaction as security, but the court also considered that the assignor had retained all conceivable risk associated to the receivables; and the assignee had unilaterally modified the financing conditions, meaning that the assignee itself treated the transaction as a secured credit line.

In Doctors Hospital\textsuperscript{33}, where re-characterization was considered in the context of a bankruptcy-remote transaction, the bankruptcy court concluded in 2013 that the transfer of receivables from the hospital to the vehicle was a ‘sale’, despite it being done under a ‘true contribution’ scheme (where the assignor received the vehicle’s equity, rather than a cash price). Since the agreement did not provide recourse by the vehicle to the Hospital with respect to the receivables if the underlying obligors did not pay, nor did it permit or require the Hospital to repurchase or substitute other receivables or property if the obligors did not pay.

In other common law countries, the approach of the court is to determine whether the nature of the recourse, and the true nature of the transaction are such that the legal rights and economic consequences of the agreement bear a great similarity to a financing transaction or to a sale.

**Seller’s retention of right to entire surplus:**

Seller’s right to reclaim the entire surplus that is the leftover after providing a particular rate of return to the buyer is indicative of a funding intent. If the transaction is so constructed that the buyer will actually earn a lender’s rate of return, and the entire surplus would flow back to the seller, the transaction is akin to a financial transaction.

In securitisation transactions, the sweep of residual surplus by the seller is quite common; however, a sophisticated structure typically provides a robust and defensible device for the same. For instance, the seller may retain an interest-only strip, or may have a subordinated right to the surplus by way of a deferred sale consideration. A generic right to sweep


\textsuperscript{32} https://law.justia.com/cases/federal/appellate-courts/F2/602/538/252513/

\textsuperscript{33}https://www.ilnb.uscourts.gov/sites/default/files/opinions/DoctorsHospital_FandC-on-Remand.pdf
the surplus, along with other indicators defeating a true sale intent, is usually not a preferred part of securitisation design.

**Seller creating a loan-type obligation**

If the seller creates a loan-type obligation to pay a fixed sum of money, that is, while the parties documented a so-called a sale of asset, but in real operation of the transaction, the seller is discharging the obligation or the liability to pay a stipulated amount month on month, irrespective of collections or actual realization from the collateral, the transaction clearly exhibits a funding intent. The cashflows of the buyer must be from the asset and not from the generalised cashflows of the seller. In many cases, it is common for the seller to continue to service the asset, and therefore, the cashflows may be paid by the seller; however, the seller should correlate the payment with the collections from the asset.

**Restrains on the buyer’s ability to resell the asset**

Next, restriction on the buyer’s right to resell or pledge the asset, while in itself may not be necessarily reflecting the intent of financing, but generally speaking, whenever in a sale, the buyer should buy the asset free from any controls of the seller. In a commercial transaction of purchase, the buyer is free to resell or pledge the asset without any intervention of the seller.

**Co-mingling of assets or cashflows**

Where the seller continues to be the servicer of the asset, it is quite likely that the seller will have assets similar to the ones which have been sold to the buyer. Generally speaking, a sale is characterised by the seller demarcating and separating sold assets so that the same are not mixed up with the seller’s identical assets. If the assets or their cashflows continue to get commingled with the seller’s own assets, the intent of selling is usually defeated.

Commingling has two practical dimensions – the systems of the seller distinguishing the sold assets versus those which are not sold. Secondly, the cashflows from the sold assets identified or separated, say, in a separate bank account Commingling of collections with the seller’s general funds is always a negative factor in true sale analysis, even if not fatal.

The other factor to determine the existence of a secured loan, and not a sale, is the continuous involvement of the assignor through the servicing of the receivables. The non-notification of rights to the account

---

34 Petron Trading Co v Hydrocarbon Trading & Transport Co, 663 F Supp 1153, 1159 (ED Pa 1986)
debtor. The retention of rights to ask the account debtor for price adjustments, the commingling of funds or the existence of recourse.

Transfer disregarding the fair value
Asset sold at below market prices may also indicate financing intent. Normally speaking, no one will sell one’s asset at substantially lower than market value. There are various rulings to the effect that if the asset has been sold at values irrelevant to fair values, the intent could not be sale. Further, post-sale transfers by the buyer back to the seller must also be made at fair market value at the time of such subsequent transfer, intending an actual sale.

There has been rulings wherein it has been held that even if the consideration of sale does not represent the market price, the transaction cannot be treated as loan transaction. The court held that "It cannot be laid down as a general principle that whenever there is a sale of property at a value lower than it is worth it will lead the irresistible inference that the transaction is in substance a loan. A price below the true value by itself cannot indicate a mortgage, nor a fair market value (FMV) can be conclusive evidence that the transaction is a sale."

Rulings in India
Tendency of Indian courts to deviate from the language of the party and look at the substance or to combine together several parts of transactions and look at the holistic picture, varies from ruling to ruling. For example, in case of securities re finance/ repurchase transaction, in a famous ruling of B.O.I. Finance Ltd vs The Custodian & Ors on 19 March, 1997, the question is discussed in detail dealing in securities repurchase. The court held that the nature of such a transaction is that it consists of two inter-connected legs, namely, the first or the ready leg, consisting of purchase or sale of certain securities at a specified price, and the second or forward leg, consisting of the sale or purchase of the same of similar securities at a letter date at a price determined on the first date.

In the case of C. Cheriathan vs P. Narayanan Embranthiri on 18 December, 2008, one of the ingredients for determining the true nature of transaction, therefore, is that the condition of repurchase should be embodied in the document which effects or purports to effect the sale. The apex court, however, assumed that the intention of the parties was that amount of consideration would remain the same. The

---

35 Unknown vs Ananta Kumar Mishra
36 https://indiankanoon.org/doc/1588871/
37 https://indiankanoon.org/doc/885461/
time for repurchase, however, has been specified. Further, there was no evidence brought on record to show that any relationship of creditor and borrower had come into being. On construction of the document in question, the court opined that the transaction represented a sale.

In a decision in the case of Chunchun Jha - Vs. - Ebadat Ali, reported in AIR 1954 SC 345 while deciding the question whether a given transaction is a mortgage by conditional sale or a sale outright with a condition of re-purchase, is a vexed one and must be decided on its own facts. The apex court held in such cases the intention of the parties is the determining factor and there is nothing special about that unless class of cases, as in every other case, where a document has to be construed, the intention must be gathered in the first place, from the document itself. The apex court held that if the words are express and clear, effect ought to be given to those and any extraneous enquiry should be ruled out. Court has given emphasis not on what the parties intended or meant to do but what is the legal effect of the words which they used in the document itself. If at all any ambiguity is apparent on the language of the documents then court is under obligation to look to the surrounding circumstances to determine the real intention expressed in the document.

**Conclusion**

Courts have not adopted a unified approach. However, there have been several rulings in the past where in case of mortgage transaction, whether the mortgage is actually a sale with the right to buyback or actually is mortgage by conditional sale. In other words the tendency of the courts to disregard the language and look at the substance is not unknown or infrequent in India. However, if the transaction is done between the parties at arm’s length and the transaction is done within the regulatory over sight, the possibility of the court disputing the true sale nature is much lesser. India, is typically a country where the form prevails unless the intent that the form is not the same as substance is very clear.

---

38 https://indiankanoon.org/doc/1855966/
FPI Investments in Indian Securitization Market

Investments by Foreign Portfolio Investors (FPIs) in unlisted debentures and securitized debt instruments (SDIs) issued by Indian companies was allowed pursuant to SEBI notification dated 27th February, 2017\(^{39}\). Earlier in November, 2016, Reserve Bank of India (RBI) had also permitted investment by FPIs in unlisted non-convertible debentures and securitized debt instruments issued by Indian companies\(^{40}\). The said amendments by the securities market regulator and financial services regulator were the final push which was needed to encourage more FPI investments in India.

Previously, FPIs could invest only in debt securities of companies engaged in infrastructure sector. This was a clear indication that the government aimed to develop the infrastructure sector in India. But eventually, it seemed that the government did not want to restrict this to infrastructure only and wanted to reap all the benefits for developing a dynamic and facilitating bond market in the country.

Economic development and smooth flow of funds into the economy are the twin sides of the same coin and the government of India has very well taken this into account while amending the FPI regulation. Allowing FPI investments in unlisted debt instruments of Indian companies, was a step by the government to relax the burden which the companies had to bear, while raising funds in form of equity. The regulation in turn blocked the companies from tapping into fresh funds and listing of debt instruments, which called for additional burden of complying with a host of other regulations.

Companies are now able to raise debt funding from foreign sources in form of unlisted debt, i.e., without listing the instrument.

Apart from unlisted debt instruments, FPI investments in SDIs has also gained a lot of popularity. SDI has been defined under SEBI (Public Offer and Listing of Securitized Debt Instruments) Regulations, 2008 as –

“securitized debt instrument” means any certificate or instrument, by whatever name called, of the nature referred to

\(^{39}\)https://www.sebi.gov.in/sebi_data/attachdocs/1488197031529.pdf
Further, section 2(h) (ie) of the Securities Contracts (Regulation) Act, 1956 defines the term ‘securities’ to include—

-ie any certificate or instrument (by whatever name called), issued to an investor by any issuer being a special purpose distinct entity which possesses any debt or receivable, including mortgage debt, assigned to such entity, and acknowledging beneficial interest of such investor in such debt or receivable, including mortgage debt, as the case may be;

However, SDIs which are eligible for FPI investments have to be –

i. any certificate or instrument issued by a special purpose vehicle (SPV) set up for securitization of asset/s where banks, FIs or NBFCs are originators; and/or

ii. any certificate or instrument issued and listed in terms of the SEBI Regulations on Public Offer and Listing of Securitized Debt Instruments, 2008.

Accordingly, instruments issued by other than the ones listed above will neither be regulated by the central bank of the country nor the securities market regulator.

Recently, RBI has further relaxed the regulations for investments by FPI, which has been welcomed by the industry at large. At the same time it has also tighten investor-wise exposure limits.

The RBI vide its notification dated 27th April, 201841, amended on 1st May, 201842 has relaxed their terms of investments in corporate bonds by FPIs. The intent behind these changes are to accelerate the demand for shorter maturity papers that matures within the span of twelve months. Treasury bills, commercial papers and certificate of deposits are few ubiquitous short-term maturity instruments.

Further, exposure limits on FPI investment in corporate bonds have also been introduced. The relevant extract of the circular is reproduced herein below:

“(e) Single/Group investor-wise limit in corporate bonds

FPI investment in corporate bonds shall be subject to the following requirements:

41https://www.rbi.org.in/Scripts/NotificationUser.aspx?id=11266&Mode=0
42https://www.rbi.org.in/Scripts/NotificationUser.aspx?id=11268&Mode=0
(i) **Investment by any FPI, including investments by related FPIs, shall not exceed 50% of any issue of a corporate bond.** In case an FPI, including related FPIs, has invested in more than 50% of any single issue, it shall not make further investments in that issue until this stipulation is met.

(ii) **No FPI shall have an exposure of more than 20% of its corporate bond portfolio to a single corporate** (including exposure to entities related to the corporate). In case an FPI has exposure in excess of 20% to any corporate (including exposure to entities related to the corporate), it shall not make further investments in that corporate until this stipulation is met. A newly registered FPI shall be required to adhere to this stipulation starting no later than 6 months from the commencement of its investments.”

Prior to change, FPIs were only permitted to invest in corporate bonds with minimum residual maturity of three years or above. Pursuant to the recent amendment, FPIs are permitted to invest in corporate bonds with minimum residual maturity of above one year. Further, investments by an FPI in corporate bonds with residual maturity below one year shall not exceed, at any point in time, 20% of the total investment of that FPI in corporate bonds. Also, on a whole, the investment by an FPI including related FPIs cannot be more than 50% of any issue of corporate bonds.

In supersession to the aforesaid notification, the RBI issued directions on June 15, 2018 which consolidated all the aforesaid provisions and allowed the FPIs registering after April 27, 2018, an extended timeline of 6 months from registration or March 31, 2019, whichever is earlier. Further, new investments, within the limit of 20% to any corporate, were exempted from the exposure limits till March 31, 2019.

RBI, in its Sixth Bi-monthly Monetary Policy Statement for 2018-19 dated February 07, 2019 had declared that for the purpose of widening the spectrum of investors in the Indian corporate bond market, it will remove the cap on investment to be made by FPIs on corporate bonds. In furtherance to the declaration, the recent circular issued by RBI dated February 15, 2019, makes an amendment to its earlier notification dated June 15, 2018. The amendment is withdrawal of imposition of cap on investment in corporate bonds issued by a single

---

43 https://rbi.org.in/Scripts/NotificationUser.aspx?id=11303&amp;Mode=0  
45 https://www.rbi.org.in/Scripts/NotificationUser.aspx?id=11475&amp;Mode=0
issuer. Henceforth, FPIs the restriction on concentration of more than 20% on a single issuer shall not apply.

However, the exposure limit on an FPI upto 50% of any issue of corporate bond is still persisting.

The major issues that need to be specifically emphasized on are –

a) whether pass through certificates (PTCs) issued by special purpose trust (SPV), under a securitization transaction, would qualify to be a corporate bond,

b) whether, residual maturity norms shall apply in case of SDIs, and

c) whether investment made in the PTCs issued by the SPV be treated as an exposure on the originator and will it fall under the aforesaid concentration limits.

Firstly, it is pertinent to note that the concentration limits are for issuance of corporate bonds. In case securities are issued by an SPV, the same does not fall under the category of corporate bond. Para 21(1) of the SEBI (Foreign Portfolio Investors) Regulations, 2014 provides a list of instruments in which FPIs can invest. The list originally included corporate securities like non-convertible debentures/bonds, shares, securities etc. issued by an Indian company. However, subsequently the regulations were amended to include securitized debt instruments issued by SPVs. It can be argued, the very intention of including the SDIs was because the instruments were not originally covered under items provided therein. Therefore, it can be safely concluded that SDIs cannot be considered as corporate bonds.

Since, SDIs are not considered as corporate bonds itself, the residual maturity limit shall also not be applicable. Hence, investment by FPIs in securitized debt instruments shall not be subjected to the minimum residual maturity requirement.

Secondly, in securitization transactions, the originator sells the receivables to the SPV on true sale and non-recourse basis. The SPV issues PTCs on a private placement basis, backed by the receivables owned by the SPV and the investors subscribes to the PTCs. The exposure of the investor is on the SPV and ultimately on the underlying receivables and not on the originator, save and except for any credit enhancement provided for the transaction which puts an obligation on the originator.

Moreover, the priority sector lending (PSL) requirements of commercial banks are also fulfilled by investing in PTCs, wherein there is a see-through approach. The regulators do not look at the PTC as a security of the issuer, but consider it based on a see-through approach for complying with the PSL requirements. Therefore, investments made in PTCs cannot be considered as exposure on the originator.

Fiscal year 2013–2014 brought a modest recovery in the level of RMBS issuance activity. Both private sector banks and public sector banks were drawn to the sector as investors, seemingly without regard to incentives for priority sector lending targets. The tax uncertainties about revenue leakage from mutual fund investments in PTC securitizations were resolved in 2013, but the funds remained edgy about making investments in PTCs.

Furthermore, in May 2013, the RBI increased the exposure limits for agricultural and micro/small/medium enterprise (MSME) sectors. This enabled many banks to achieve greater priority sector lending volumes through their own loan originations and reduced their dependence on purchasing securitizations from third parties (often NBFCs) for meeting their priority sector lending requirements. However, priority sector assets—either loans or securities backed by priority sector loans—tend have low yields and can depress a bank’s after-tax returns. This creates an incentive for banks to invest in securitizations backed by no priority sector assets in order to achieve balance sheet growth with higher returns. It remains to be seen whether this will have an enduring impact on the industry in the long run.

The bottom line is that the flow of regulatory and tax changes has created a tumultuous environment for the Indian securitization market over the past several years. The changes have unsettled market participants and disrupted the orderly evolution of the market. For better or worse, the regulatory and tax changes have altered the market’s future course. Regulators have consistently intended to promote securitization as a beneficial financial technology within the context of the country’s growing capital markets. However, their actions have not always carried out their intent. Unfortunately, the recent wave of regulatory and tax changes may have done more to impede market development than to support it.

The recent actions of the government suggest that they are looking forward to make an environment that will facilitate the growth of securitization in India. A lot of credit must be extended to the Indian Securitization Foundation, which has played an important role in helping regulators identify the problems in the market.
The restriction that an FPI can invest only 50% in a corporate debt issuance should not be applicable to PTC because in case of PTCs, the exposure is on the underlying loans and not on the originator. The performance of the PTC does not depend on the performance of financial health of the originator.
FAQs on section 115TCA of the Income Tax Act, 1961

Introduction

The regulatory changes in the securitization industry in the last few years have caused a see-saw swing in securitization volumes. The revised guidelines on securitization of standard assets issued in 2012 had brought back the PTCs regime only for it to fall out of favour with the introduction of distribution tax on securitization trusts. Distribution tax was introduced with the intent to curb revenue leakage envisaged by the tax authorities in case of income received by mutual funds from investments in PTCs. The industry had made several representations to explain that world over, securitization SPVs are pass-through in nature and that it would defeat the purpose of creating a conduit if tax was deducted at the time of distribution.

The Union Budget, 2016 has corrected this anomaly by replacing the distribution tax with tax deducted at source. ISF had played a lead role in explaining why distribution tax would have a negative impact on the industry. The change in the tax provisions were much awaited by the industry and hopefully will bring back the PTCs transactions allowing the markets to grow beyond direct assignments.

In this section we have attempted to address some of the questions that arise out of the proposed tax changes in the recent budget.

Overview of the provisions

1. **What are the tax changes introduced in the budget pertaining to securitization trusts? How do the provisions compare with the provisions of the existing law?**

The Finance Bill, 2016 has proposed following amendments pertaining to securitization trusts:

---

47 Finance Act, 2013 introduced Chapter XII EA in the Income Tax Act, 1961 pursuant to the provisions of which, the income distributed by the securitization trusts would be subject to distribution tax at the rates specified in Section 115 TA of the Income Tax Act, 1961. Income received by the investors would be exempt from tax in the hands of the investors.
a) Distribution tax not applicable: Sub-clause (5) of section 115TA is introduced to say that distribution tax as provided for in section 115TA shall not be applicable for income distributed by the trust to its investors on or after 1st June, 2016.

b) Section 115TCA introduced: The section starts with a non-obstante clause, saying that any income accruing or arising to, or received by, a person, being an investor of a securitization trust, out of investments made in the securitization trust, shall be chargeable to income-tax in the same manner as if it were the income accruing or arising to, or received by, such person, had the investments by the securitization trust been made directly by him.

c) Section 194LBC introduced: Section 194LBC has been introduced whereby the income payable to a resident investor by a securitization trust shall be subject to tax deduction at source at the rate of 25% for individual or HUFs and at the rate of 30% for any other person. In case of a non-resident investor or a foreign company, the rates in force shall apply.

d) Security receipts included as securities: Security receipts have been included in the definition of securities. Any investor who holds securities, issued by securitization trusts shall be considered investor for the purpose of the chapter.

e) Securitization trusts to include trusts set up by asset reconstruction companies: The definition of securitization trusts has been amended to include trusts set-up by a securitization company or a reconstruction company formed, for the purposes of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

2. Do sections 115TA to 115TC become redundant with effect from the implementation date of sec. 115TCA?

No. the provisions will remain relevant for the purpose of definition of terms used in sec. 115TCA. Note that Explanation below sec. 115TC starts with the words “for the purposes of this Chapter”.

3. From when are the pass-through provisions applicable?

The exemption from distribution tax is applicable from 1st June, 2016. The proposed section for pass-through (section 115TCA) is applicable for income-year 2016-17. Also, Section 10 (35A) which was granting the

48 “security receipt” shall have the same meaning as assigned to it in clause (zg) of sub-section (1) of section 2 of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002. Briefly speaking, security receipts are used in acquisition of non-performing assets by asset reconstruction companies, which usually acquire them on the books of a trust, by issuing security receipts to the investors.
tax exemption to distributed income has not been deleted. However, a proviso has been inserted to provide that nothing in the said section shall apply to distribution of income on or after 1st June, 2016. Therefore, for distributions made till 1st June 2016, there will be confusion as to whether sec 115TA applies, or sec 115TCA.

4. Is there a total pass-through for securitization trusts?

There is pass-through for securitization trusts. However, any income credited to the investor by the securitization trusts shall be subject to tax deduction at source under section 194LBC of IT Act. While the income is subject to tax deduction at source, the investor will be able to get full credit for tax paid. In case of tax exempt investors such as mutual funds, or other investors not likely to have as much tax liability, the investors may apply to the tax officer of relevant jurisdiction for certification at NIL rate of deduction of tax at source.

5. From when will section 115 TCA come into force?

The provisions of section 115TCA shall be applicable from 1st April, 2017. This implies that the provisions will be applicable for income year 2016-17.

Scope of applicability

6. What sort of securitization trusts are the provisions of Chapter XII EA applicable to?

Chapter XII EA of IT Act includes the following types of securitization trusts:

a) Special Purpose Distinct Entity49 as defined under section 2 (1)(u) of Securities and Exchange Board of India (Public Offer and Listing of Securitized Debt Instruments) Regulations, 200850;

49 “special purpose distinct entity” means a trust which acquires debt or receivables out of funds mobilized by it by issuance of securitized debt instruments through one or more schemes, and includes any trust set up by the National Housing Bank under the National Housing Bank Act, 1987 (53 of 1987) or by the National Bank for Agriculture and Rural Development under the National Bank for Agriculture and Rural Development Act, 1981 (61 of 1981)
b) Special Purpose Vehicle as defined by the guidelines on securitization of standard assets;

c) Special Purpose Vehicle which fulfils conditions as specified by RBI;

d) Trusts set up by a securitization company or a reconstruction company for the purposes of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

7. What sort of securities will the provision of Chapter XII EA applicable to?

The term “securities” now includes security receipts.

Securities mean debt securities issued by a Special Purpose Vehicle as referred to in the guidelines on securitization of standard assets issued by the Reserve Bank of India.

Security receipts shall have the same meaning as assigned to it in clause (zg) of sub-section (1) of section 2 of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

8. Will the provisions of Chapter XII EA be applicable to securitization trusts outside the purview of Chapter XII EA?

The provisions of Chapter XII EA of IT Act are applicable to such securitization trusts that are defined under the chapter (see responses to question 5 above). Any other securitization trust outside the specified framework may not be eligible for the pass through structure. Since pass through is granted by specific provision of law, and is, by presumption, not applicable unless the trust is treated as a “special purpose vehicle” defined in sec 115TC, it will remain highly uncertain to expect a pass through treatment in case of any other securitization trust.

51 ‘SPV’ means any company, trust, or other entity constituted or established for a specific purpose - (a) activities of which are limited to those for accomplishing the purpose of the company, trust or other entity as the case may be; and (b) which is structured in a manner intended to isolate the corporation, trust or entity as the case may be, from the credit risk of an originator to make it bankruptcy remote;


53 Currently no conditions have been prescribed by RBI

54 "security receipt" means a receipt or other security, issued by a securitization company or reconstruction company to any qualified institutional buyer pursuant to a scheme, evidencing the purchase or acquisition by the holder thereof, of an undivided right, title or interest in the financial asset involved in securitization;
Manner of Taxation

9. **What are the principles of tax proposed under Finance Bill 2016?**

The principles of tax may be summed as follows:

a) The nature of income, for example, business, profits or capital gains, in the hands of the investors will be the same as the nature of income in the hands of the SPV.

b) The income is taxed, in the hands of the investor, at the time of distribution of the income, or, if the income is not distributed, that is, accumulated, then, at the time of crediting the income to the credit of the investor.

c) Income remaining undistributed will be deemed credited to the investors in accordance with the respective investors’ entitlement. That is to say, there is no possibility of using the securitization SPV as a tax shelter.

10. **How the securitization trusts are going to be taxed after the insertion of Section 115 TCA?**

The income distributed, or credited by the securitization trusts shall be subject to tax deducted at source and not distribution tax. Note that there is a deemed credit, by virtue of sec. 115TCA (3) if the income is accumulated at the end of the financial year by the trust.

11. **How are the investors in securitization transactions going to be taxed after the insertion of Section 115 TCA?**

As per the provisions of section 115TCA, any income accruing or arising to, or received by, a person, being an investor of a securitization trust, out of investments made in the securitization trust, shall be chargeable to income-tax in the same manner as if it were the income accruing or arising to, or received by, such person, had the investments by the securitization trust been made directly by him.

The income of the investors shall be subject to tax deduction at source at the time of distribution. Such income will taxable in the hands of the investors. The investors will get full credit for the tax deducted at source.

12. **While pass-through provisions are applicable from 1st June, 2016, the taxation on investors shall be applicable from 1st April, 2017, what is the implication of the same? Is there a timing mismatch?**
The provisions of distribution tax are exempt from 1st June, 2016. The provisions of pass-through are applicable from 1st April, 2016. For income distributed in April and May, 2016, distribution tax will be applicable as the exemption is from 1st June, 2016 and the income shall also be taxable in the hands of the investors as the pass-through is granted since 1st April, 2016.

Therefore, there seems to be a confusion on how the income accruing/credited/arising in April and May 2016 shall be subject to tax. While the provisions of section 115TCA starts with a non-obstante clause, it may be argued that a later provision overrides an earlier provision, and therefore, there will be no distribution tax for the 1st April 2016. At the same time, the provision for deduction of tax at source in sec. 194LBC applies from 1st June 2016. To avoid confusion, trusts may take steps to defer distribution by till 1st June 2016.

13. **Section 10(35A) provided for an exemption in the hands of the investors with respect to the income received from securitization trusts as per Section 115TA, what will be the status of this exemption after 1st June, 2016?**

Section 115TCA has an overriding impact. Further a proviso has been inserted to provide that nothing in the said section shall apply to distribution of income on or after 1st June, 2016. Thus, on account of the above proposed amendment, exemption under section 10(35A) will be not be available from 1st June 2016.

14. **Section 115TCA is applicable on “income distributed” or on any income accrued to the investors?**

The provisions of section 115TCA is applicable on any income accruing, arising or received. Whether distributed/credited or not if the income has accrued, it shall be deemed to have been credited on the last day of the previous year.

15. **What happens to the income distributed by securitization trusts under the existing transactions, between 1st April, 2016 and 1st June, 2016?**

As discussed in question 11 above, there is no clarity on the income distributed by securitization trusts between 1st April, 2016 and 1st June, 2016.
16. Under section 115 TCA (4) the securitization trusts are required to furnish a statement giving details of income distributed or credited during the previous year. Will the format of statement under section 115 TA (3) be used for statement required under section 115 TCA (4)?

There is a provision for prescription of a format prescribed under section 115 TCA (4).

17. What are the provisions of section 194LBC pertaining to income distributed by securitization trusts?

Section 194LBC, applicable from 1st June 2016, states that the income payable to:

a) Resident investor by a securitization trust shall be subject to tax deduction at source at the rate of
   i. 25% for individual or HUFs and
   ii. 30% for any other person.

b) In case of a non-resident investor or a foreign company, the rates in force shall apply.

18. Will TDS provisions be levied on income distributed/ credited to mutual funds as well?

Section 197 of the IT Act, requires the assessee to apply to the assessing officer to get a certificate for lower rate of TDS being applicable to the assessee. The AO having satisfied may allow TDS to be deducted at the rate specified in the certificate. As far as the trust is concerned, the trust will have to deduct tax at source unless it receives a NIL or lower deduction certificate from the investor.

19. Will the TDS provisions be applicable on Excess Interest Spread as well?

The basis of taxability under sec. 115 TCA is either of these: (a) distribution or crediting of income; or (b) if income is not distributed or credited, then, the entitlement to such income as at the end of the income year. As regards excess spread, usually, transactions may provide for a pass-through of the excess spread, or it’s trapping and pooling to create or replenish a cash reserve, to serve as a liquidity or credit support. In any event, if it is clear that the excess spread is available for the credit of the originator, then the excess spread will be deemed to be the income of the originator. However, if the excess spread has been retained by way of credit enhancement, such that
there is no clarity as to who is “entitled” to such income, then the accumulated income is not liable to be taxed as the income of the originator, as there is no entitlement in such case.

20. **Will over collateralisation be subject to tax deduction at source?**

Over collateralisation is merely creating a security. Therefore receivable forming part of the seller’s interest shall not be subject to tax deduction at source.

21. **Have the TDS provisions nullified the removal of distribution tax?**

Deduction of tax at source is not as bad as suffering distribution tax, for several reasons:

1. The investor gets full credit for tax paid.
2. The investor may seek a certificate for deduction of tax at lower rate. If the investor is tax exempt, say, in case of a mutual fund, the investor may apply for certification at NIL rate of deduction of tax at source.

22. **Can FPIs now invest in PTCs?**

As an annexure to the budgetary speech, the Finance Minister seems to have permitted foreign portfolio investors (FPIs) to invest in securitization vehicles. So far, FPIs were permitted to invest in security receipts issued by ARCs, but not in securitization transactions. However appropriate provisions have to be inserted in the FPI regulations for the proposed amendment to take effect.

23. **The tax u/s 115TCA is applicable to “income” of the securitization trust. Is it correct to say that income of the trust will have to be computed applying the usual principles of computation of income under the income tax Act?**

Yes, the understanding is correct. Sec. 115TCA exposes to tax income of the securitization trust in the hands of the investors. In that sense, it is a vicarious tax that the investors pay on the income determined in the hands of the trust. The income will first have to be determined after allowing all such deductions as are claimable in the hands of the trust. Once the income is determined, it becomes taxable in the hands of the investors.

24. **What is the point of time when the income becomes taxable?**
In view of a combined reading of sec 115TCA (2) and (3), the manner, the point of taxability is earliest of:

1. Distribution
2. Giving of credit to investors
3. at the close of the financial year

25. Several securitization transactions require an income to be retained – say, in a cash reserve account. Is this income to be credited to investors, or will this income also be liable to be taxed in the hands of the investors?

The credit enhancement structures in several transactions require pooling of income, trapping of income or redirection of income. These incomes are retained, pooled or redirected to be used as credit support. For example, if the transaction requires a cash reserves to be maintained in the transaction, whether the reserve will be used for paying off senior investors in time to come or it will be used to go back to the originator is not known at the time of trapping.

The question of a tax on investors arises only where the investors are determinate. If an income is accumulated or retained, but there are no determinate investors, there is no question of tax on the investors.

26. Is it correct to say that the basis of taxation of income earned by the trust in the hands of investors is the entitlement to income by the investors?

Sec 115TCA (3) gives an impression that the entitlement to income is the basis in case of income which is neither distributed, nor credited to the account of the investors. That is, in case of accumulation with no corresponding clear entitlement, there is no question of tax in the hands of investors.

27. Is it possible to contend that a securitization trust pooling income, without any clear identifiable investor, may be taken as a representative assessee, liable to tax at MMR?

Sec 115TCA starts with a non obstante provision. Therefore, there is no question of tax applying rep tax principles.
GST on securitisation transactions

Transitioning into GST, assessing its impact on business and taking appropriate measures to bring about tax neutrality/efficiency are the prime concern for all and sundry. GST also has an impact on the securitization transactions in India which now happens to be Rs. 1.9 lakh crores odd industry. In this Chapter we are broadly trying to deal with GST impact on securitization of standard as well as non-performing assets and its various facets.

In India, securitization is undertaken through the PTC route (issuance of pass-through certificates or direct assignments. The distinction is not relevant when we talk about securitization of non-performing assets through asset reconstruction companies.

GST implications on PTC transactions

The implications of GST will have to be mulled over at each stage of the securitization transaction. A securitization transaction will have the following facets:

a. Assignment of receivables by the originator to an SPV
b. SPV acquiring receivables on discount
c. SPV issuing PTCs to investors and servicing PTCs over the term
d. Originator receives servicing fees for collections/recovery of receivables
e. Originator receives excess interest spread (EIS) in the transaction after servicing of the investors with the receivables collected.

There is one more issue of whether the SPV will be considered as a related person as defined under the CGST Act.

Below is a detailed analysis.

i. Requisites of Taxability under GST

Section 9 of the CGST Act provides for levy and collection of CGST on all intra-State supplies of goods or services or both.

Hence, there must be “goods” or “services” or “both”, and the same shall be supplied.

“Goods” are defined in section 2(52) as –
“(52) “goods” means every kind of movable property other than money and securities but includes actionable claim, growing crops, grass and things attached to or forming part of the land which are agreed to be severed before supply or under a contract of supply;”

“Services” are defined in section 2(102), as –

“services’ means anything other than goods, money and securities but includes activities relating to the use of money or its conversion by cash or by any other mode, from one form of currency, or denomination to another form of currency and denomination for which a separate consideration is charged. Money is therefore excludible from the scope of ‘goods’ and ‘services’.

Section 7 details the scope of the expression “supply”. According to the section, “supply” includes “all forms of supply of goods or services or both such as sale, transfer, barter, exchange, licence, rental, lease or disposal made or agreed to be made for a consideration by a person in the course or furtherance of business.” However, activities as specified in Schedule III of the said Act shall not be considered as “supply”.

It may be noted here that “Actionable claims, other than lottery, betting and gambling” are enlisted in entry 6 of Schedule III of the said Act; therefore are not exigible to GST.

The discussion below studies the nature of “receivables” and seeks to determine whether assignment of receivables will be treated as a supply of goods or services within the purview of the GST law.

Nature of “Receivables”

There is no doubt that a “receivable” is a movable property. “Receivable” denotes something which one is entitled to receive. Receivable is therefore, a mirror image for “debt”. If a sum of money is receivable for A, the same sum of money must be a debt for B. A debt is an obligation to pay, a receivable is the corresponding right to receive.

A “debt” is a sum of money which is now payable or will become payable in the future by reason of a present obligation, depitum in praesenti, solvendum in future. See, Web v. Stendon, (1883) 11 Q.B.D. 518, 572; Kesoram Industries and Cotton Mills Ltd. v. CWT, 1966 AIR 1370 : 1966 SCR (2) 688.

Coming to the definition of “money”, it has been defined under section 2(75) as follows –
“money” means the Indian legal tender or any foreign currency, cheque, promissory note, bill of exchange, letter of credit, draft, pay order, traveller cheque, money order, postal or electronic remittance or any other instrument recognised by the Reserve Bank of India when used as a consideration to settle an obligation or exchange with Indian legal tender of another denomination but shall not include any currency that is held for its numismatic value.”

The definition above enlists all such instruments which have a “value-in-exchange”, so as to represent money. A debt also represents a sum of money and the form in which it can be paid can be any of these forms as enlisted above.

So, in effect, a receivable is also a sum of “money”. As such, receivables shall not be considered as “goods” or “services” for the purpose of GST law.

ii. Receivables vis-à-vis Actionable Claims

As mentioned earlier, “actionable claims” have been included in the definition of “goods” under the CGST Act, however, any transfer (i.e. supply) of actionable claim is explicitly excluded from being treated as a supply of either goods or services for the purpose of levy of GST.

Section 2(1) of the CGST Act defines “actionable claim” so as to assign it the same meaning as in section 3 of the Transfer of Property Act, 1882, which in turn, defines “actionable claim” as –

“actionable claim” means a claim to any debt, other than a debt secured by mortgage of immovable property or by hypothecation or pledge of movable property, or to any beneficial interest in movable property not in the possession, either actual or constructive, of the claimant, which the civil courts recognise as affording grounds for relief, whether such debt or beneficial interest be existent, accruing, conditional or contingent;”

It may be noted that the inclusion of “actionable claim” is still subject to the exclusion of “money” from the definition of “goods”. The definition of actionable claim travels beyond “claim to a debt” and covers “claim to any beneficial interest in movable property”. Therefore, an actionable claim is definitely more than a “receivable”. Hence, if the actionable claim represents property that is money, it can be held that such form of the actionable claim shall be excluded from the ambit of “goods”.
There are views which, on the basis of the definition above, distinguish between -- (a) a debt secured by mortgage of immovable property, and a debt secured by hypothecation/pledge of movable property on one hand (which are excluded from the definition of actionable claim); and (b) an unsecured debt on the other hand. However, the author opines that a debt, whether secured or unsecured, is after all a “debt”, i.e. a property in money; and thus can never be classified as “goods”. Therefore, the entire exercise of making a distinction between secured and unsecured debt may not be relevant at all.

In case it is argued that a receivable which is secured (i.e. a secured debt) shall come within the definition of “goods”, it must be noted that a security granted against a debt is merely a back-up, a collateral against default in repayment of debt.

iii. Assignment of receivables as “Supply”

Though, the fact that a debt is merely a representation of “money” and therefore there is no question of any “supply” under the GST law, yet it is important to study the scope of the word “supply” in this context.

In one of the background materials on GST published by the Institute of Chartered Accountants of India55, it has been emphasized that a transaction where a person merely slips into the shoes of another person, the same cannot be termed as supply. As such, unrestricted expansion of the expression “supply” should not be encouraged:

“... supply is not a boundless word of uncertain meaning. The inclusive part of the opening words in this clause may be understood to include everything that supply is generally understood to be PLUS the ones that are enlisted. It must be admitted that the general understanding of the world supply is but an amalgam of these 8 forms of supply. Any attempt at expanding this list of 8 forms of supply must be attempted with great caution. Attempting to find other forms of supply has not yielded results however, transactions that do not want to supply have been discovered. Transactions of assignment where one person steps into the shoes of another appears to slip away from the scope of supply as well as transactions where goods are destroyed without a transfer of any kind taking place.”

---

A simple example of assignment of receivable is – A sells goods to B. B owes a certain sum of money to A. This sum of money is “receivable” in the hands of A. A has the right to get that sum from B. A decides to pass that right to C. He therefore, assigns the receivable to C, for a certain consideration. Therefore, A is actually passing on the benefits under the contract with B, to C. C is merely stepping into the shoes of A. There is no separate supply as such.

Also, as already stated, where the object is neither goods nor services, there is no question of being a supply thereof.

iv. Servicing Fees
Typical to a securitization transaction is that the originator continues to do the collection of receivables from the obligors for and on behalf of the SPV. The originator, therefore acts as a servicing agent and charges a servicing fees.

Under the current tax regime, servicing fees was subject to 15% service tax, charged by the originator to the SPV. The SPV would typically not be able to claim set off and this would be a sunk cost.

This cost under the GST regime goes up to 18%. Therefore if the servicing fee is 50 basis points, the increase in cost is 9 basis points. Since SPV cannot claim the set off, the GST is a dead loss.

In India, the typical servicing fee charged is 25 basis points. Whether or not the consideration for taxable supply of service is reasonable would depend upon the type of a pool. For instance, if the pool is a microfinance pool or a granular pool, it may not seem reasonable to charge a servicing of 25 bps as against a car loan pool. Therefore, where the servicing fee does not seem at arm’s-length, it may be challenged that servicing fees is not adequate consideration or the only consideration for collection of receivables.

Further, if it was to be contested that the SPV is a related person to the originator as defined under the CGST Act, then the servicing fees charged could be subject to valuation rules which will subject the servicing fees to reasonable determination of value of such supply of service by the assessing officer.

v. SPV a related person?
One of the issues during securitization transaction structuring is to ensure that an SPV is a distinct entity from legal and accounting perspective. It would be relevant to have independence established of the SPV from tax perspective as well.

The definition of related persons under CGST is as follows:
For the purposes of this Act,—

(a) persons shall be deemed to be “related persons” if—

(i) such persons are officers or directors of one another’s businesses;

(ii) such persons are legally recognised partners in business;

(iii) such persons are employer and employee;

(iv) any person directly or indirectly owns, controls or holds twenty-five per cent. or more of the outstanding voting stock or shares of both of them;

(v) one of them directly or indirectly controls the other;

(vi) both of them are directly or indirectly controlled by a third person;

(vii) together they directly or indirectly control a third person; or

(viii) they are members of the same family;

(b) the term “person” also includes legal persons;

(c) persons who are associated in the business of one another in that one is the sole agent or sole distributor or sole concessionaire, howsoever described, of the other, shall be deemed to be related

One of the ways of establishing that the SPV and the originator are related persons, is by establishing control by the originator. The term control has not been defined under CGST and therefore, one may have to rely on accounting tests for control.

As per the accounting standards, if the originator is controlling the SPV, it would lead to consolidation thereby frustrating the purpose of doing securitization itself.

So, to avoid consolidation it is pertinent to avoid control by the originator over the SPV. If there is no control, the other parameters for falling into related person definition could be meandered.

However, if the transaction structure was such that control could be established then the transaction is subject to arm’s-length test and valuation rules.
vi. Treatment of EIS component

Another critical issue in structuring securitization transactions is how the excess interest spread or EIS will be swept by the originator from the transaction. Typically, transactions are devised to give residuary sweep to the originator after servicing the PTCs. Therefore there could be a challenge that EIS is also a component of servicing fees or consideration for acting as a servicing agent. The meaning of consideration\(^{56}\) under the CGST Act is consideration in any form and the nomenclature supports the intent of the transaction.

Since, the originator gets excess spread, question may arise, if excess spread is in the nature of interest. Therefore it is important to structure excess spread as IO strip.

Going forward it would be rather recommendable that the sweep of excess spread is structured as IO strip. Since it is interest only.

vii. Servicing of PTCs

Another facet of securitization transaction that needs attention from GST perspective, is taxability of servicing of coupon and repayment of PTCs. PTCs being securities, servicing of securities is exempt from applicability of GST.

viii. GST on Securitization – Global Overview

Since the Indian GST law is largely inspired by EU VAT laws, it would be quite relevant to go through UK and EU precedents pertaining to securitization and factoring transactions. It is important to understand that in every loan sale, securitization, factoring or assignment of receivables, the common thread is the assignment of receivables. Hence, if the assignment of receivables is taken as a “supply”, then, in each of these cases, there would be a question of applying VAT on the entire turnover, that is, the entire consideration involved in the supply of receivables.

In UK, a distinction is drawn between “sale of debt” and “assignment of debt”. The sale of a debt is a financial transaction, whereby the

\(^{56}\) (31) “consideration” in relation to the supply of goods or services or both includes—
(a) any payment made or to be made, whether in money or otherwise, in respect of, in response to, or for the inducement of, the supply of goods or services or both, whether by the recipient or by any other person but shall not include any subsidy given by the Central Government or a State Government;
(b) the monetary value of any act or forbearance, in respect of, in response to, or for the inducement of, the supply of goods or services or both, whether by the recipient or by any other person but shall not include any subsidy given by the Central Government or a State Government:

Provided that a deposit given in respect of the supply of goods or services or both shall not be considered as payment made for such supply unless the supplier applies such deposit as consideration for the said supply;
purchaser acquires ownership of debts from a creditor, at a nominal sum to the face value of the debts. The purchaser assumes all the rights and obligations of the original creditor and all legal and beneficial or equitable interest passes to the buyer to whom full title and risk is transferred. However, in an assignment only the equitable interest is passed to the assignee and the assignor retains the legal interest in the debt and any liability to obligations arising from the original contract. Often it will not be possible for the assignee to sell that which has been assigned.

The distinction is akin to the distinction between “assignments of a contract” and “assignment of benefits under contract” as pointed out in the article titled, “Law of Assignment of Receivables”, Vinod Kothari. The sale of a debt is exempt from VAT under the VAT Act 1994, Schedule 9, Group 5, item 1. And, the assignment or re-assignment of a debt is not a supply for VAT purposes.

In Finanzamt Gross Gerau v. MKG Kraftfahrzeuge Factory GmbH, the European Court of Justice had to examine whether, in case of factoring transaction, VAT was applicable on the entire turnover of receivables, or was it applicable only on the commission charged by the factor for the assumption of the risk of default or other services of the factor. In this ruling, the ECJ held factoring to be an economic activity, by way of exploitation of the debts to earn an income by providing a service to the factor’s clients; however, it is not the debt itself which is a supply, but the commission charged by the factor.

In MBNA Europe Bank v. Revenue and Customs Commissioners, (2006) All ER (D) 104 (Sep); [2006] EWHC 2326 (Ch.), the Chancery Court discussed whether a credit card securitization amounts to a taxable supply for VAT purposes. After elaborate discussion on the nature of securitization, and referring to findings of lower authorities that securitization is nothing but a sophisticated form of borrowing, the Chancery Court held that the assignment of receivables in a securitization was not a supply at all.

58 https://www.gov.uk/hmrc-internal-manuals/vat-financial-vatfin3215; pg. last visited on 19.05.2018
59 http://www.bailii.org/ew/cases/EUECJ/2003/C30501.html; pg. last visited on 19.05.2018
60 http://www.bailii.org/cgi-bin/markup.cgi?doc=ew/cases/EWHC/Ch/2006/2326.html; pg. last visited on 19.05.2018
The position thus held by Courts is well accepted by the administration itself. UK HMRC’s Internal Manual clearly puts the tax position on securitization as follows:

The assignment of the assets by the originator

The assignment of the receivables by the originator to the SPV is not a supply for VAT purposes. It is simply the fulfilment of a pre-condition so that the SPV can provide its ‘securitization’ service.

The issue of securities to fund the purchase of the assets

The issue of a security for the purposes of raising capital is not a supply for VAT purposes (see VATFIN4250).

The administration of the assets

The servicer is the entity that deals with the receivables on a day to day basis, administering and collecting them and transferring the funds to the SPV, normally whilst maintaining the original contract with the underlying debtors. The servicer will receive a fee for this service from the SPV which is generally set at a percentage of the aggregate balance of the loans/receivables or the funds collected. The servicer services are supplies to the SPV in the course of an economic activity and the servicer fee is consideration for that supply.

GST implications on Direct Assignment transactions

In case of direct assignment, as in case of PTCs transaction, the assignment of receivables will be tax exempt (going by the same rationale, as in case of securitization transactions).

The servicing fees charged to the buyer, would be subject to GST. The only reprise here being that the buyer would be a bank or an NBFC and would be able to claim set off on the GST levied.

GST implications on sale of Non-Performing Loans (NPLs)

In case of sale of NPLs to an asset reconstruction company (ARC), the receivables are acquired by a trust floated by an ARC. The receivables usually are not on the books of the ARC directly.

In case of ARCs, it would be a very strong contention that the trust of the ARC is a related person to the ARC and therefore the management fees, the carry amount etc charged by the managers would be subject to valuation rules.
With regard to the security receipts (SRs) issued by the ARCs, the taxability of such SRs would be the same as in case of PTCs, as both are securities and therefore not falling under taxable supply.

**Clarification by GST Council**

The GST Council has discussed the issue of assignment and securitisation of receivables through different question\(^{61}\), extracts have been reproduced below:

40. *Whether assignment or sale of secured or unsecured debts is liable to GST?*

Section 2(52) of the CGST Act, 2017 defines ‘goods’ to mean every kind of movable property other than money and securities but includes actionable claim. Schedule III of the CGST Act, 2017 lists activities or transactions which shall be treated neither as a supply of goods nor a supply of services and actionable claims other than lottery, betting and gambling are included in the said Schedule. Thus, only actionable claims in respect of lottery, betting and gambling would be taxable under GST. Further, where sale, transfer or assignment of debts falls within the purview of actionable claims, the same would not be subject to GST.

Further, any charges collected in the course of transfer or assignment of a debt would be chargeable to GST, being in the nature of consideration for supply of services.

41. *Would sale, purchase, acquisition or assignment of a secured debt constitute a transaction in money?*

Sale, purchase, acquisition or assignment of a secured debt does not constitute a transaction in money; it is in the nature of a derivative and hence a security.

65. *What is the leviability of GST on securitization transactions undertaken by banks?*

Securitized assets are in the nature of securities and hence not liable to GST. However, if some service charges or service fees or documentation fees or broking charges or such like fees or charges

are charged, the same would be a consideration for provision of services related to securitization and chargeable to GST.

The fallacy starts with two sequential and separate questions: one dealing with securitisation and the other on assignment transactions. There was absolutely no need for incorporating separate questions for the two, since all securitisation transactions involve an assignment of debt.

Next, the department in Question 40 has clarified that the assignment of actionable claims, other than lottery, betting and gambling forms a part of the list of exclusion under Schedule III of the CGST Act, therefore, are not subject to GST. This was apparent from the reading of law, therefore, there is nothing new in this.

However, the second part of the answer needs further discussion. The second part of the answer states that – any charges collected in the course of transfer or assignment of a debt would be chargeable to GST, being in the nature of consideration for supply of services.

There are multiple charges or fees associated in an assignment or securitisation transaction – such as servicing fees or excess spread. While it is very clear that the GST will be chargeable on servicing fees charged by the servicer, there is still a confusion on whether GST will be charged on the excess spread or not. Typically, transactions are devised to give residuary sweep to the originator after servicing the PTCs. Therefore, there could be a challenge that sweep right is also a component of servicing fees or consideration for acting as a servicing agent. The meaning of consideration under the CGST Act (defined above) is consideration in any form and the nomenclature supports the intent of the transaction.

Since, the originator gets the excess spread, question may arise, if excess spread is in the nature of interest. This indicates the need for proper structuring of transactions, to ensure that either the sweep right is structured as a security, or the same is structured as a right to interest. One commonly followed international structure is credit-enhancing IO strip. The IO strip has not been tried in Indian transactions, and recommendably this structure may alleviate concerns about GST being applied on the excess spread.

Till now, whatever has been discussed was more or less settled before the clarification, question 41 settles the dispute on the contentious question of whether GST will be charged on assigned of secured debt. The answer to question 41 has compared sale, purchase, acquisition or
assignment of secured debt with a derivative. The answer has rejected
the view, held by the authors, that any right to a payment in money is
money itself. The GST Council holds the view that the receivables are in
the nature of derivatives, the transaction qualifies to be a security and
therefore, exempt from the purview of supply of goods or supply of
services.

While the intent of the GST Council is coming out very clear, but this
view is lacking supporting logic. Neither the question discusses why
assignments of secured receivables are not transactions in money, nor
does it state why it is being treated as derivative.

Our humble submission in this regard is that assignment of secured
receivables may not be treated as derivatives. The meaning of the term
“derivatives” have been drawn from section 2(ac) of the Securities
Contracts (Regulation) Act, 1956, which includes the following –

(A) a security derived from a debt instrument, share, loan,
whether secured or unsecured, risk instrument or contract for
differences or any other form of security;

(B) a contract which derives its value from the prices, or index of
prices, of underlying securities.

In the present case, assignment of receivables do not represent any
security nor does it derive its value from anything else. The receivables
themselves have an inherent value, which get assigned, the fact that it
is backed a collateral security does not make any difference as the value
of the receivables also factor the value of the underlying.

Even though the logic is not coming out clear, the intent of the Council
is coming out clearly and the efforts made by the Council to clear out
the ambiguities is really commendable.

Conclusion
It is established that the GST regime requires mollification in the existing
transaction structures such that tax inefficiency in the change of regime
can be avoided.

It is important that we understand these nuances to avoid tax litigations
at a later stage.

The securitization industry as gone through several rounds of regulatory
changes – some favorable and some not. From change in the regulatory
guidelines of RBI to distribution tax applicability and subsequent roll-over. There have been several seasons of changes to come to some momentum as on date.

Therefore it is important to take cognizance of the changes and make the appropriate stitch now to save the nine later!
Accounting for securitization is one of the significant motives of securitization itself. If a transaction of securitization fails to achieve off-balance sheet treatment, then several of the significant drivers for securitization will cease to be relevant. This only explains why it is crucial to ensure, of course subject to conditions, that the transaction does achieve off-balance sheet treatment.


In case of IFRS/IndAs, the accounting principle for financial instruments are contained in IFRS 9/IndAS 109.

For the sake of clarity on definition terms, the key expressions in respect of financial instruments are (a) financial asset; (b) de-recognition; and (c) on going valuation or fair valuation.

Securitization mostly consists of financial assets. A financial asset is defined by IND AS 32 to mean any asset that is:

a. Cash;
b. An equity instrument of another entity;
c. A contractual right:
   i. To receive cash or another financial asset from another entity; or
   ii. to exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity; or

d. a contract that will or may be settled in the entity’s own equity instruments and is:
   i. a non-derivative for which the entity is or may be obliged to receive a variable number of the entity’s own equity instruments; or
ii. a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity’s own equity instruments. For this purpose the entity’s own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity’s own equity instruments.

Since a receivable consists of right to receive money, they will form part of “financial assets”.

Off-balance sheet treatment, in accounting parlance, is called “de-recognition”, implying the reversal of recognition. When the financial asset, already on the books of the originator, is removed from there, it is a case of de-recognition.

Transition into IFRS

RBI vide its “Statement on Developmental and Regulatory Policies” dated 5th April, 2018 have extended the applicability of IND AS for banks by a year. Earlier scheduled commercial banks (“SCBs”) excluding Regional Rural Banks (“RRBs”) were required to implement IND AS from 1st April, 2018 vide RBI circular dated 11th February, 2016.

In context of NBFCs there is currently no clarity as they are governed by MCA rules. Hence, no extension still.

Financial sector entities are required to adopt IFRS (IND AS) from the financial year 2019 i.e. from 1st April 2019. Therefore there is a shift from AS to IND AS from the above financial year and consequently differences will have to be adjusted for. This period is known as transition period. So a question arises that what would happen to transactions undertaken prior to, on and after the transition date?

To understand the implication of the above question we will have to first understand the meaning of transition date as given in IND AS 101 or IFRS 1. IND AS 101 or IFRS 1 contains the provision guiding the first time adoption of IND AS financial statements and as per the provisions,

62 https://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/PR264270719E5CB28249D7BCE07C5B3196C904.PDF
63 https://rbi.org.in/Scripts/NotificationUser.aspx?id=10274&Mode=0
transition date happens to be earliest date of the previous financial year construed from the year in which the entity is required to follow IFRS. Thus to illustrate, if a financial entity is required to follow IFRS from the year 1/4/2019 – So transition date for the entity will be 1/4/2018. Therefore the opening balances as on 1st April, 2019 are required to be IFRS compliant, and therefore, effectively, the entity has to in-parallel adopt IFRS in 2018-19 as well. So there is great impact of transition to IND AS on the financial sector entities from 1/4/2019.

Pre transition accounting
Indian Accounting Standard (IND AS) 109 – Financial Instruments is applicable from the year 2018. Therefore currently, there is no standard as such dealing with securitization for such companies on which International Financial Reporting Standards (IFRSs) is not applicable. Therefore for the interim period i.e. from 2015 to 2018, there are no standards governing the accounting for securitization in existence.

The metamorphosis from India’s Generally Accepted Accounting Principles (GAAP) to Ind AS is a watershed in the accounting world of India. India is converging to International Financial Reporting Standards (IFRS) in a phased manner starting from annual periods commencing on or after 1st April, 2016. Ind AS will be the IFRS converged standard comprising various carve outs from IFRS. Prior to embracing the IND AS concerning securitization in spirit and in letter, entities have to understand the implication of the transition and adoption of IFRS, which has been taken care of in the matter below.

At the outset it must be noted that the fair value of the financial instrument should be determined in accordance with the principles enunciated in IND AS 113 Fair Value Measurement.

Current Accounting standards for securitization in India
The transition has resulted in the birth of Accounting Standards (AS) and Indian Accounting Standards (Ind AS) relating to securitization transaction in India. Thus knowledge of both can prove beneficial to the organizations dealing with securitization. The IND ASs are required to be followed by only select companies as prescribed by MCA. Therefore there are two sets of accounting standards which is required to be followed. Accounting for securitization is dealt with by:

- AS 30,31 and 32 (for companies following AS)
- IND AS 109 (for companies following IND AS)

The ICAI had originally promulgated AS 30 (based on IAS 39), which was kept in abeyance, and subsequently repealed while IND AS 109 is
applicable from the year 2018 (for financial sector entities). Therefore currently, there is no standard as such dealing with securitization for such companies on which IND AS is not applicable.

Current accounting treatment in India
The accounting for the different aspects of the securitization transaction has been illustrated below:

**De-recognition**
- The market practice is to go by true-sale. Every securitization transaction is presumably a true sale and is backed by a legal opinion saying so. Therefore, practitioners treat the legal sale as evidence of off-balance sheet treatment.

**Profit recognition**
- Securitization guidelines of 2012 provide that the originator shall not recognize gains on sale even if the gains are encashed upfront. The originator will park the same in Gains on sale as a liability and release the same linearly based on the receivables accruing.

**Consolidation**

Accounting standards 21 – *Consolidated Financial Statements* [AS 21] is currently based on voting rights as the basis of consolidation. Since Special Purpose Vehicles (SPVs) are structured so that voting rights are not exercisable by the originator, transactions never lead to consolidation of the SPV with the originator.

**Securitization accounting under IFRS (IND AS)**
The financial year 2018-2019 will see Ind AS taking shape as far as financial entities are concerned.

**Phase 1**
- Companies having net worth of INR 500 crores or more, listed and non-listed.
- Holding, associates, subsidiaries and joint ventures of these companies.
- Comparative information required for the period ending 31st March 2018 or thereafter.

**Phase 2**
- NBFCs whose equity and/or debt securities are listed or are in the process of listing on any stock exchange in India or outside India and having a net worth less than INR 500 crore.
- Non-listed companies with net worth of INR 250 crores or more and not covered in Phase 1.
- Holding, associates, subsidiaries and joint ventures of these companies.
- Comparative information required for the period ending 31st March 2019 or thereafter.
Relevant IFRSs

IFRS 9 – *Financial Instruments* for principles and conditions of de-recognition

IFRS 10 – *Consolidated Financial Statements* for consolidation of the SPV

IFRS 12 – *Disclosure of Interests in Other Entities* for certain disclosures as may be applicable to an unconsolidated structured entity

Decision making pertaining to de-recognition

The conditions of de-recognition are stated in Para 3.2.6 of IFRS 9. There may be essentially 3 situations:

- **De-recognition**
  - In case of transfer of substantially all risks and returns.

- **No De-recognition**
  - In case of retention of substantially all risks and returns.

- **Partial De-recognition**
  - Retention of some risks and returns – however, surrender of control.

Risk & Return

Risk, in case of typical securitization transactions, is the exposure to credit risk of the transaction.

Return is compensation for risk and represented by excess spread.

Note: The risks and returns were with the originator prior to the transaction of securitization. One has to compare the impact a transaction makes on the originator’s exposure to risks and returns after the transaction, so as to see whether there is a significant transfer of risks/returns.
Consolidation and structured entity disclosures (IFRS 10 & 12) (IND AS 110 & 112)

The question of consolidation or disclosures as required in case of structured entities under IFRS 12 will arise only after it has been established that the transaction is a de-recognition transaction.

IFRS 10 will take care if there is an on-going selection of assets (for example, in case of revolving transactions). If IFRS 10 is applicable, and the transaction has been able to achieve de-recognition under IFRS 9, then consolidation may be done on the following principles:

- Between the two principles of consolidation that is exposure to risks and ability to control, the latter will prevail.
- The term control is correlated with relevant activities i.e. the activities which decide the economic results of the enterprise or activity carried by the entity.
- The vehicles carry no activities in case of securitization vehicles. However, entity’s risks and returns are affected by the selection of the assets. If the originator selects the assets, then it is likely that it may be argued that the originator has control over the entity, and therefore, the entity may require consolidation back with the originator.
- On the contrary, if it can be established that the control, that is, selection of assets, etc., are based on the decisions of an independent expert [say an investor representative] then the transaction may avoid control with the originator. Note that typically, the trustee of the SPV is independent, and there are several legal controls with the trustee rather than with the originator.
- In short, possibility of consolidation may be avoided through structuring of the SPV.

Impact of transition to IFRS on securitization transaction

The standard is to be applied retrospectively upon transition; however restatement of comparatives is not required. On the date of transition, management is required to disclose information surrounding the reconciliation of impairment allowances between IAS 39/IAS 37 and IFRS 9. Entities need to be aware that consolidation requirements have not changed and that holders of securitization notes will need to apply the new requirements on contractually linked instruments. These are
specific classification and measurement requirements designed for investors of asset-backed notes where the classification partly depends on the degree of subordination of the notes held relative to all notes issued by the issue.

Criteria for de-recognition

The basic situations for de-recognition of financial assets are in para 3.2.3, 3.2.4 and 3.2.5 of IFRS 9. The three paras respectively deal with 3 situations (these are not conditions of off-balance sheet treatment):

- Extinguishment or expiry of rights in financial assets – for example, all cash flows underlying an asset are collected and nothing remains;
- Legal transfer of financial asset;
- No legal transfer, but creation of a pass-through obligation.

The first situation is not applicable at the time of a securitization transaction – hence, this is not being discussed here.

Relevance of true sale

The legal transfer of a financial asset, and there being no legal transfer but creation of a pass-through obligation, are the commonest situations applicable in case of securitization. Of particular relevance is para 3.2.5 dealing with retention of contractual rights to the cash flows (that is, no true sale). The common belief is that “true sale” is the pre-condition for off-balance sheet treatment. This is not the case, since the accounting standard recognizes, subject to conditions, the possibility of an off-balance sheet treatment even where there is no contractual transfer. The three conditions for proceeding ahead to examine the test for off-balance sheet treatment are:

(a) The entity has no obligation to pay an amount to eventual recipients unless there are collections from the underlying pool;
(b) The entity is obligated to pay cash flows from the underlying pool to the eventual recipients, that is, the entity cannot elect not to pay, having collected the cash flows;
(c) The entity is prohibited from recycling, reinvesting or using the cash flows as collateral for any borrowing.

In essence, these 3 conditions resonate the substance-over-form stance of IFRS. True sale, and accounting off-balance sheet are two independent conditions. Thus, each of the following possibilities, in Table exist:

---

Note:
If the whole understanding and logic of IFRS 9 and 10 is extended to the Non-Performing Loans (NPLs) securitization, there appears a major debacle coming through. Banks offload their junk assets (NPLs) through securitization trusts formed by the Asset Reconstruction companies (ARCs). These securitization trusts issue security receipts (“SRs”) to the investors backed by the NPLs. Generally 85% of the SRs are subscribed by the originator. Now going by the risk and reward criteria, the risk necessarily stays with the originator only. Therefore under the IFRS provisions, there may not be any de-recognition at all. This will thus require the banks to maintain continued provisions with regard to the NPLs and there may not be any relief even if the asset is transferred to the ARCs. Therefore the whole edifice on which the ARCs are working gets frustrated.
<table>
<thead>
<tr>
<th>Legal True sale</th>
<th>Accounting off balance sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

The risks and rewards test

Para 3.2.6 lays the most commonly cited test for off-balance-sheet, the risks and rewards test.

What are the risks and rewards?

The expressions “risks and rewards” or “risks or rewards” are used repetitively enough over accounting standards. Ownership is essentially a bunch of benefits and burdens. Usually, ownership, that is, legal title, moves with benefits and burdens thereof, but in case the two are dissociated, accounting standards will look at the transfer of benefits and burdens, rather than transfer of legal title.

Use of expressions “risks and rewards” or “risks or rewards” should not make any difference, as, generally, speaking, risks and rewards go together. It would be counter-intuitive to expect the two to be separated, as rewards are a compensation for risks. In any case, if there are rewards, the risk of not getting the same is a risk, and is there is a risk, the probability of not being hit by the same is a reward.

Depending on the financial asset in question, the analyst may first have to list out the risks and the rewards. Typically, in case of securitization, we have pool of cash flows arising out of loans. The reward is the benefit of the net interest margin, commonly called as excess spread. The right to sweep the excess spread or residual profit, irrespective of in what form, is the reward arising out of a pool of loans.

The risks that affect the residual profit are several – delinquencies, defaults, prepayments, interest rate risk, foreign exchange risk, etc.

Essentially, the net result of the risks and rewards is the residual profit of the originator from the loan pool.

The risks/rewards test in para 3.2.6 three alternative scenarios:

- Significantly all risks/rewards transferred – cleanest case of derecognition
No significant transfer of risks/rewards – no de-recognition
Neither of the two scenarios, that is, partial transfer of risks and rewards – we apply the surrender of control test.

While we discuss the surrender of control test below, the most important question is – how does one determine whether there is a significant transfer of risks/rewards? Obviously, the question must lend itself to numerical determination, rather than being a subjective smell-test.

The risks/rewards test is mostly applied by examining the exposure to variability of net cash flows, or residual cash flows, before and after the transaction.

Before the transaction, the originator is exposed to all the risks, and sweeps all the rewards. There are numerous scenarios, having different probabilities. Thus, the variability of the net cash flows may be assessed by taking the expected value (that is, probability weighted value) of the cash flows. Likewise, an expected value is computed under the securitization scenario as well, using the same probable scenarios. If the two expected values of residual cash flows are not substantially different, one would argue that there is no significant transfer of risks and rewards.

Bringing this numerical work, which may be quite complicated as there may be ‘n’ scenarios for ‘m’ number of risks, leading to total of \(n^m\) scenarios, it may be possible to conceptualize the usual exposure of the originator to risks/rewards. Originator typically holds the equity tranche – the thickness of the equity tranche is indicative of the extent of default risk retained by the originator. If the equity tranche is thick enough, such that the next tranche is AAA rated, it is obvious indication that the originator has done so much risk retention as to reduce the risk of the senior class to AAA-level. Another risk that the originator takes it the exposure of the excess spread to risk of defaults. The excess spread is prone to risk of defaults in either case – pre and post-securitization. However, if excess spread is thick enough, such that defaults would, in most probable scenarios, get absorbed by the excess spread, it is unlikely that the transaction will meet the condition of de-recognition.

Surrender of control

The next test for de-recognition is surrender of control. If the risks/rewards condition is not met, but there is a surrender of control, the transaction may still qualify for partial de-recognition, and will stay on books only to the extent of “continuing involvement”.
Surrender of control is tested by examining the practical ability of the transferee, that is, the SPV, to retransfer the asset. The stress is on the word practical ability, not contractual. Mostly, SPVs are non-operative entities. If the risks/rewards criteria is not met, it is difficult to qualify for de-recognition on the basis of surrender of control.

**What would happen to transactions undertaken prior to, on and after the transition date?**

Prior to answering the above question we shall understand the meaning of transition date as explained by as explained in IND AS 101 - First-time Adoption of Indian Accounting Standards or IFRS 1 - First-time Adoption of International Financial Reporting Standards. IND AS 101 or IFRS 1 contains the provision guiding the first time adoption of IND AS financial statements and as per the provisions, transition date happens to be earliest date of the previous financial year construed from the year in which the entity is required to follow IFRS. Thus to illustrate, if a financial entity is required to follow IFRS from the year 1/4/2018 – So transition date for the entity will be 1/4/2017. Therefore the opening balances as on 1st April 2018 are required to be IFRS compliant, and therefore, effectively, the entity has to in-parallel adopt IFRS in 2017-18 as well. So there is great impact of transition to IND AS on the financial sector entities from 1/4/2018.

The accounting treatment of the securitized transaction have massive impact on the financial entities. The cornerstone of securitization is to achieve off-balance sheet accounting treatment. The exordium of IFRS has deprived securitization of its advantage as it will no more be possible for the entities to put assets off-balance sheet. Reading Para B2 and Para B3 of the IFRS 1 or IND AS 101, it is very clear that in respect of de-recognition of financial assets as per existing Indian GAAP, the assets will still be on the balance sheet from the year 2017-18 if de-recognition does not meet the criteria as set out by IND AS 109.

In accordance with para B2, a first time adopter of IND AS is required to adopt the de-recognition requirements in IND AS 109 prospectively for transactions occurring on or after the date of transition to IND ASs. Hence financial assets and liabilities that has been derecognized by an entity in accordance with the erstwhile Indian GAAP, as a result of transaction that occurred before the date of transition to IND AS, it shall not recognize those assets and liabilities in accordance with IND ASs, unless they qualify for recognition as a result of a later transaction or event. Simply put the following situation will arise:
Conclusion

Convergence with IFRS will have a huge impact on the financial statements of the entity. Not only will it transform the perspective of accounting for securitization but also the premise of accounting in the country. Currently, in the absence of any accounting standard governing the accounting for securitization, assets are taken off books once there is legal sale or true sale without giving any consideration to transfer of risk and rewards while voting rights determine the position for consolidation. However, post IFRS convergence, the asset will be only put off-books only if:

- There is a whole or substantial transfer of risk or reward, and
- The originator does not control the SPV and is not exposed to the variable interest in the SPV.

Therefore achieving off-balance sheet balance under the umbrella of IFRS might be unattainable. This would have a hard hitting effect on the securitization of NPLs, which will stay off the books despite being transferred to the ARCs. Thus it seems the whole idea for securitization gets frustrated. However, it will be interesting thing to watch as to what carve outs would be given to the financial sector entities and how does the convergence fares in the coming year.
De-Recognition Test

1. If SPV comes for consolidation, apply criteria at group level
   → Determine whether component approach to assets applicable; if not apply at aggregate level

2. Have the rights to the cash flow from asset expired
   → Derecognize the asset

3. Has the entity transferred its contractual rights over cash flows?
   → Has the entity assumed pass-through obligations from the cash flows of the asset?

4. Continue to recognize the asset

5. Has the entity transferred all substantial risks and rewards?
   → Derecognize the asset

6. Has the entity retained all substantial risks and rewards?
   → Continue to recognize the asset

7. Has the entity retained control of the asset?
   → Derecognize the asset

8. Continue to recognize the asset to the extent of continuing involvement
Accounting for Direct Assignment under Indian Accounting Standards (Ind AS)

Introduction

Direct assignment (DA) is a very popular way of achieving liquidity needs of an entity. With the motives of achieving off-balance sheet treatment accompanied by low cost of raising funds, financial sector entities enter into securitisation and direct assignment transactions involving sale of their loan portfolios. DA in the context of Indian securitisation practices involves sale of loan portfolios without the involvement of a special purpose vehicle, unlike securitisation, where setting up of an SPV is an imperative.

The term DA is unique to India, that is, only in Indian context we use the term DA for assignment of loan or lease portfolios to another entity like bank. Whereas, on a global level, a similar arrangements are known by various other names like loan sale, whole-loan sales or loan portfolio sale.

In India, the regulatory framework governing Das and securitisation transactions are laid down by the Reserve Bank of India (RBI). The guidelines for governing securitisation structures, often referred to as pass-through certificates route (PTCs) were issued for the first time in 2006, where the focus of the Guidelines was restricted to securitisation transactions only and direct assignments were nowhere in the picture. The RBI Guidelines were revised in 2012 to include provisions relating to direct assignment transactions.

Until the introduction of Indian Accounting Standards (Ind AS), there was no specific guidance regarding the accounting of direct assignment transactions, therefore, a large part of the accounting was done in accordance with the RBI Guidelines. The introduction of Ind ASes have opened up several new challenges for the financial entities.

Following issues are relevant:

1. Whether DA would lead to de-recognition?
2. Whether there will be a gain on sale upon such de-recognition?
3. Whether DA should be be treated as a partial transfer of asset or transfer of the whole asset?
4. Continuing valuation of retained interest?
In this article, we intend to discuss those issues and suggest potential solutions for those as well.

**De recognition in case of Direct Assignment**

Ind AS 109, provides a clear guidance as to the de recognition principles to be followed. Para 3.2.2 says that:

“3.2.2 Before evaluating whether, and to what extent, derecognition is appropriate under paragraphs 3.2.3–3.2.9, an entity determines whether those paragraphs should be applied to a part of a financial asset (or a part of a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety, as follows.

(a) Paragraphs 3.2.3–3.2.9 are applied to a part of a financial asset (or a part of a group of similar financial assets) if, and only if, the part being considered for derecognition meets one of the following three conditions.

(i) The part comprises only specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, paragraphs 3.2.3–3.2.9 are applied to the interest cash flows.

(ii) The part comprises only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of all cash flows of a debt instrument, paragraphs 3.2.3–3.2.9 are applied to 90 per cent of those cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the cash flows provided that the transferring entity has a fully proportionate share.

(iii) The part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of interest cash flows from a financial asset, paragraphs 3.2.3–3.2.9 are applied to 90 per cent of those interest cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the specifically identified cash flows.
provided that the transferring entity has a fully proportionate share.

(b) In all other cases, paragraphs 3.2.3–3.2.9 are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety). For example, when an entity transfers (i) the rights to the first or the last 90 per cent of cash collections from a financial asset (or a group of financial assets), or (ii) the rights to 90 per cent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8 per cent of the principal amount of the receivables, paragraphs 3.2.3–3.2.9 are applied to the financial asset (or a group of similar financial assets) in its entirety.”

If the derecognition criteria is not met in entirety, then all the conditions mentioned in para 3.2.2(a) has to be satisfied, which talks about fully proportionate share of total cash flows from the financial asset and fully proportionate share of specifically identified cash flows of the financial asset. If these conditions are met, then partial derecognition is possible. The part that is still recognized, is not connected with derecognition and further accounting related to derecognition. However, for actually derecognizing the asset, the derecognition criteria in para 3.2.3 and para 3.2.6 has to be looked at.

Para 3.2.3 goes as follows:

“3.2.3 An entity shall derecognise a financial asset when, and only when:

(a) the contractual rights to the cash flows from the financial asset expire, or

(b) it transfers the financial asset as set out in paragraphs 3.2.4 and 3.2.5 and the transfer qualifies for derecognition in accordance with paragraph 3.2.6.”

Thus, if the contractual rights to the cashflows expire, then the asset can be de-recognized. If the condition is not met, then it has to be seen that whether the asset is transferred as per para 3.2.5 and the transfer meets the derecognition conditions set out para 3.2.6.

Para 3.2.6 states that:

“3.2.6 When an entity transfers a financial asset (see paragraph 3.2.4), it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In this case:
(a) if the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.

(b) if the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity shall continue to recognise the financial asset.

(c) if the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, the entity shall determine whether it has retained control of the financial asset. In this case:

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

(ii) if the entity has retained control, it shall continue to recognise the financial asset to the extent of its continuing involvement in the financial asset (see paragraph 3.2.16).”

Para 3.2.6 brings out that, if all the risks and rewards of ownership of financial asset is transferred, then the asset shall be derecognised. If the risks and rewards incidental to ownership of financial asset is not transferred, then obviously the asset cannot be derecognised. However, if there is a partial transfer of risks and rewards of ownership, then the surrender of control has to be evaluated. If there is surrender of control, then the asset can be derecognised. If not, there shall be partial de-recognition, that is, the asset shall be recognized in the books of the seller only to the extent of continuing involvement.

Refer the flowchart on de-recognition of financial assets presented earlier in this booklet.

**Computation of Gain on Sale**

It is a general notion that a sale results in a gain or loss, be it arbitrary or anticipated, the same is required to be accounted for. In case of a direct assignment, there is a sale of the loan portfolios, however, the same completely depends upon whether the assigned loan portfolio is getting derecognised from the books of the assignor or not. If it is not derecognised from the books of the assignor, then the question of recognising a gain or loss on sale does not arise. However, if the sale qualifies for de-recognition, then the seller must book gain or loss on sale in the year of sale.
Upon reading of Ind AS 109 and study of example stated in application guidance in para B3.2.17, the way of computing the same can be derived as follows:

\[
\text{Gain on sale} = \text{Sale consideration} - \frac{\text{Carrying value of asset} \times \text{Fair value of transferred portion}}{(\text{Fair value of transferred portion} + \text{Fair value of retained portion})}
\]

This can be explained with the help of the following example:

Assume an entity has a portfolio of prepayable loans whose coupon and effective interest rate is 10 per cent and whose principal amount and amortised cost is Rs. 10,000. It enters into a transaction in which, in return for a payment of Rs. 9,115 (Sale consideration), the transferee obtains the right to Rs. 9,000 of any collections of principal plus interest thereon at 9.5% per annum. The entity retains rights to Rs. 1,000 of any collections of principal plus interest thereon at 10%, plus the excess spread of 0.5% on the remaining Rs. 9,000 of principal. Collections from prepayments are allocated between the entity and the transferee proportionately in the ratio of 1:9, but any defaults are deducted from the entity’s interest of Rs. 1,000 until that interest is exhausted.

The entity calculates the gain or loss on the sale of the 90% share of cash flows. The fair value of the 10% transferred is calculated taking the present value of the total cash flows received by the entity and the fair value of the transferred portion is Rs. 9,115.

Therefore, the Gain on Sale works out be:

\[
\text{Rs. } 9115 - \{(\text{Rs. } 9000 \times \text{Rs. } 9115)/(\text{Rs. } 9115 + \text{Rs. } 700)\} = \text{Rs. } 757
\]

The gain or loss on sale does not depend on the sale consideration completely. There may be cases where the carrying value of the transaction and sale consideration are same, i.e. at par transactions. As per Ind AS 109, the computation of gain on sale remains same in cases of at-par or premium structured transactions, however, even at-par transactions could lead to a gain or loss on sale.

The reason for same is that the computation of gain on sale takes into account the retained interest by the Assignor comprising of the difference between the interest on the loan portfolio and the applicable rate at which the direct assignment is entered into with the assignee, also known as the right of excess interest spread (EIS) sweep.

The above settles for the computation of the gain/loss, however, the bigger change seen in the present regime is on the part of recognition of such a gain in the books of the Assignor.

In the present scenario, Ind AS 109 prescribes that the gain on sale or derecognition be recorded upfront in the profit and loss statement.
For reference, para 3.2.12 states that:

“3.2.12 On derecognition of a financial asset in its entirety, the difference between:

(a) the carrying amount (measured at the date of derecognition) and

(b) the consideration received (including any new asset obtained less any new liability assumed) shall be recognised in profit or loss.”

Further in case of derecognition of a part of financial asset, para 3.2.13 states that:

“3.2.13 If the transferred asset is part of a larger financial asset (eg when an entity transfers interest cash flows that are part of a debt instrument, see paragraph 3.2.2(a)) and the part transferred qualifies for derecognition in its entirety, the previous carrying amount of the larger financial asset shall be allocated between the part that continues to be recognised and the part that is derecognised, on the basis of the relative fair values of those parts on the date of the transfer. For this purpose, a retained servicing asset shall be treated as a part that continues to be recognised. The difference between:

(a) the carrying amount (measured at the date of derecognition) allocated to the part derecognised and

(b) the consideration received for the part derecognised (including any new asset obtained less any new liability assumed) shall be recognised in profit or loss.”

Hence, it is clear that the gain on derecognition should be recorded in the profit and loss statement.

From a practical standpoint, the above recognition is seen as a demotivation for entering into a direct assignment transaction, since the same would result in a volatility or irregularity in the profit or loss statement of the NBFCs.

This approach is in stark contrast to what has been prescribed in the RBI Guidelines on Securitisation, which requires gain on sale to be amortised over the life of the transaction. As per the RBI Guidelines provide the following:
As per para 20.1 of RBI Guidelines on Securitisation of Standard Assets issued in 2006:

“In terms of these guidelines banks can sell assets to SPV only on cash basis and the sale consideration should be received not later than the transfer of the asset to the SPV. Hence, any loss arising on account of the sale should be accounted accordingly and reflected in the Profit & Loss account for the period during which the sale is effected and any profit/premium arising on account of sale should be amortised over the life of the securities issued or to be issued by the SPV.”

Also, as per para 1.4.1. of RBI Guidelines on Securitisation of Standard Assets issued in 2012:

“The amount of profit in cash on direct sale of loans may be held under an accounting head styled as "Cash Profit on Loan Transfer Transactions Pending Recognition" maintained on individual transaction basis and amortised over the life of the transaction.”

As the accounting treatment offered by Ind AS defaces the profit and loss statement by distorting the income recognition pattern of the NBFCs, NBFCs are not in favour of recording this gain upfront. The concern is aggravated due to the liquidity crunch currently faced by the NBFCs caused by recent downfall of IL&FS. The default on payment obligations of loans and deposits amounting to approximately Rs. 90,000 crore, by India’s leading infrastructure finance company, shook the confidence of the lenders and triggered a panic sentiment amongst the market lenders including NBFCs. As a result of the panic, banks are unwilling to lend to the NBFCs and their cost of funds are going up. However, the banks are showing interest in acquiring their loan portfolios instead. Therefore, the NBFCs are somewhat being forced to accept this distortion in their profit or loss statement.

Another question that arises is- whether de-recognition in books of assignor affects recognition in the books of the assignee.

As per para 3.1.1 of Ind AS 109, an entity shall recognise a financial asset or a financial liability in its balance sheet when, and only when, the entity becomes party to the contractual provisions of the instrument. Therefore, the transferee should recognise the financial asset or financial liability in its balance sheet only when he becomes a party to the contractual provisions of the instrument.

Para B3.2.15 of the same standard, provides that if a transfer of a financial asset does not qualify for de-recognition, the transferee does not recognise the transferred asset as its asset. In such a case the
The transferee is required to derecognise the cash or other consideration paid and recognises a receivable from the transferor. The transferee may measure the receivable at amortised cost (if it meets the criteria in paragraph 4.1.2) if the transferor has both a right and an obligation to reacquire control of the entire transferred asset for a fixed amount (such as under a repurchase agreement).

Therefore, de-recognition from the books of the seller is clearly a determinant for recognition in the books of the buyer.

**Impact on GST on the gain on sale**

In the last couple of years, if there is anything that has bothered the financial entities in India, other than IndAS, then it has to be GST. Therefore, it becomes pertinent to take a look at whether GST will become applicable in any manner whatsoever.

Under GST regime, assignment of loans are treated as dealing in securities and are therefore exempted from GST. Link to our detailed writeup in this regard has been provided in the footnote 64.

**Reporting of Retained Interests**

A partial de-recognition is where the transferor transfers only a part of the asset and retains a part of it.

Currently, as per the RBI Guidelines, NBFCs are required to comply with the minimum retention requirement of 10%, that is, they should have a continuing interest of 10% on the loans that it intends to transfer. Therefore, if an NBFC is intending to sell of a portfolio of Rs. 100 crores, it has to retain at least 10% of the said portfolio and can sell of only Rs. 90 crores representing the remaining part.

Therefore, this becomes a classic case of partial de-recognition.

The value of retained interest should be accounted for as per the original accounting criteria as and when it was originated. For instance, if the pool recognised under FVOCI method, the retained interest must continue to be valued at FVOCI.

The manner of recognition or valuation of the retained interest will not change when a part of the pool is sold off.

---

Conclusion

Before the introduction of Indian Accounting Standards, RBI guidelines were followed for de recognizing the asset and recording the gain on sale after de recognition. There was no accounting guidance for financial instruments and their de recognition. In the absence of it, RBI guidelines were followed which talked about true sale. In case, the conditions of true sale were satisfied, then the asset was de recognized and the gain was regularised over the period by amortising the gain on de recognition.

While a well-documented piece of legislation is welcomed, however, every new thing has some shortcomings. In this case, the irregularities in the profit and loss and the complexities surrounding the de-recognition test comes as shortcomings. However, it is expected, with the passage of time, these shortcomings will also be settled.
Servicing Asset and Servicing Liability: A new by-product of securitization under Ind AS 109

Securitisation has gained popularity in India in the recent times, however, one more concept that has grown parallel to it is, direct assignment. In fact, at times, direct assignments have overpowered securitisation in the Indian market. Financial institutions have been using these extensively to address their liquidity issues. However, if there is anything that affected the financial institutions dearly, then it is the change in the accounting treatment under the Indian Accounting Standards (Ind AS).

The Ind AS 109 has given securitization/ direct assignment accounting in the books of the transferor and the transferee a whole new shape. One of the new concept that has arisen under the new standard is creation of servicing asset or servicing liability.

In this article we intend to cover this new concept at length.

**Servicing Asset and Servicing Liability**

In a securitization/ direct assignment transaction, the servicing of the underlying pools is retained by the transferor, for which it earns a servicing fee. Where, the compensation received for performing the servicing function is more than adequate, then, a servicing asset has to be created for the excess amount. However, where the compensation received for the servicing function is inadequate, the same must be recognized as a servicing liability in the books of the transferor.

In order to clarify the nature of a “servicing asset” and a “servicing liability”, reference is drawn from para 3.2.10 of Ind AS 109 which states that:

*If an entity transfers a financial asset in a transfer that qualifies for derecognition in its entirety and retains the right to service the financial asset for a fee, it shall recognise either a servicing asset or a servicing liability for that servicing contract. If the fee to be received is not expected to compensate the entity adequately for performing the servicing, a servicing liability for the servicing obligation shall be recognised at its fair value. If the fee to be received is expected to be more than adequate compensation for the servicing, a servicing asset*
shall be recognised for the servicing right at an amount determined on the basis of an allocation of the carrying amount of the larger financial asset in accordance with paragraph 3.2.13.

Why is it a part of securitization?

The so-called servicing asset arises as an integral part of a transaction of securitisation or direct assignment. It arises when the financial asset is transferred to the Special Purpose Entity (SPE), but the originator retains the right to service the asset in exchange for a fee, which might give rise to a servicing asset or a servicing liability. Servicing asset or servicing liability arises as a by-product of securitization. The originator may or may not assume the role of a servicer, but if it does, then he charges a servicing fee for that. The relationship between actual servicing fee and normal servicing fee, results in either a servicing asset or servicing liability. In that sense, it is a carve-out from the composite asset, that is, the larger asset pre-securitisation. However, for creation of servicing asset or servicing liability, de-recognition of the assets is an important precondition.

Splitting of Composite Asset

Servicing asset or servicing liability is created after dismantling or de-recognizing the larger pre securitization financial asset. For this purpose, splitting up of composite asset is to be done. When carrying out the splitting exercise, Ind AS 109 clearly lays out the method of decomposing the composite larger financial asset into the transferred portion and the retained servicing asset.

Please refer to the following paragraph:

3.2.13 If the transferred asset is part of a larger financial asset (eg when an entity transfers interest cash flows that are part of a debt instrument, see paragraph 3.2.2(a)) and the part transferred qualifies for derecognition in its entirety, the previous carrying amount of the larger financial asset shall be allocated between the part that continues to be recognised and the part that is derecognised, on the basis of the relative fair values of those parts on the date of the transfer.

For this purpose, a retained servicing asset shall be treated as a part that continues to be recognised.

The difference between:

(a) the carrying amount (measured at the date of derecognition) allocated to the part derecognised and
(b) the consideration received for the part derecognised (including any new asset obtained less any new liability assumed) shall be recognised in profit or loss.

In case of recognizing a service liability, liability for service obligation is recognised at Fair Value. In case of servicing asset, service asset is recognised for servicing right at an amount after carving out the servicing asset from the carrying amount of larger financial asset. The carrying amount of the larger composite asset is split between a part that is transferred, hence derecognised and another part that is recognised as servicing asset. This splitting of composite asset is done based on the fair value of both the parts as on the date of transfer. When allocating the carrying amount, it is required to measure the servicing asset at its fair value. This fair value can be arrived in two ways. One, when there exists a history of sale of similar parts or when market transactions for such parts exist, it would be best to take the actual transaction as an estimate of fair value. Two, if there are no such sale history or market quotes available, fair value can be arrived at by deducting the purchase consideration from the fair value of entire financial assets.

How does servicing asset translate into income over time?
Since the carrying value of the servicing asset is the present value, the present value will be unwound over time. Given the fact that the servicing fee in the present case is collected only at the end of the term, assuming that the valuation estimates do not change, the discounting charges will regularly be credited, with a corresponding debit to the value of the servicing asset. As a result, at the point of time when the servicing fee is to be received, the carrying value of the servicing fee is the same as the nominal amount of servicing fee receivable.

How does the value of servicing fee get re-evaluated over time
In the present case, possibly, the valuation of the asset will change as the probabilities of hitting the benchmark change over time. This will be a valuation gain/loss. Over time, as the chances or probability of collection from the obligor improve, then the servicing fee to be collected from the bank will also increase. However, if the probabilities of collection deteriorate, then service fee to be collected from bank will go down.

Recognition of Income - as Gain on Sale
When an originator assumes the responsibility of servicing the underlying loan pool, he undertakes to collect the payment from
obligors, keep a certain percentage of it as servicing fee and transfer the remaining cashflow to the SPE. Here, the originator is assuming two roles – first, that of a transferor or assignor and second, that of a collection and servicing agent.

Please refer to the following paragraph from Ind AS 109:

3.2.12 On derecognition of a financial asset in its entirety, the difference between:

(a) the carrying amount (measured at the date of derecognition) and

(b) the consideration received (including any new asset obtained less any new liability assumed)

shall be recognised in profit or loss.

Example:

Co. X is the originator of the loans, say 90% of the portfolio is sold, and Co. X assumes the role of a servicer. The disbursements from the portfolio is to be collected by X and then is to be disbursed to Bank Y (SPE). Upon successful collection by X, it will be compensated with the contractual cash flows as compensation. These cash flows are the retained servicing asset portion out of the transaction. Meaning, it is a carve-out of the part transferred leaving a lesser value. These contractual cash flows are to be recognised instead of the part de-recognised as the servicing asset.

The pre securitisation asset must be de recognised from the books of the originator if it meets the de recognition principles laid down in Ind AS 109. Then, separately a servicing asset or servicing liability will be recognised as discussed above.

Please refer to the following paragraph from Ind AS 109:

3.2.12 On de recognition of a financial asset in its entirety, the difference between:

(a) the carrying amount (measured at the date of derecognition) and

(b) the consideration received (including any new asset obtained less any new liability assumed)

shall be recognised in profit or loss.

Based on above excerpt, once the servicing asset comes out from the composite asset [Servicing asset debit, composite asset credit], the
carrying value of the composite asset stands reduced. Hence, the difference between the Purchase consideration and the appropriated value of the composite asset (after all retained assets have been carved out) leads to a gain on sale. Hence, the income that needs to be recognised upon creation of servicing asset is – a **gain on sale**.

**Accounting of servicing asset or liability- upfront/ over the period/ rear-ended?**

The accounting is to be upfront as the originated asset (loan portfolio) is to be derecognized upon transfer and a servicing asset/liability is to be reported depending upon the compensation. The servicing asset is the present value of the servicing fee. The discounting rate applied on the servicing fee depends on the seniority of the servicing fee. For example, in a model where computation of the expected value of the servicing fee is done using various scenarios and their respective probabilities, the risk inherent has already been captured in the expected value computation.

**Some relevant FAQs**

**Servicing fee is receivable as per the collection agent. The SPE has the right to change the collection agent in the specified scenarios. Whether this has any impact on the timing of recognition of the income?**

The ability of the SPE to change the servicing asset is, hopefully, on incurring of any events of default. It is not intuitive that the incentive servicing fee may be declined by arbitrary change of servicing agent.

**If the originator is required to raise invoice for servicing fee at the end of the tenure. How the same would be accounted?**

The GST invoice for the servicing fee will be raised only when the same is actually accrued as per contract. Yes, there is a disconnect between GST invoicing and recognition of the servicing asset. Incidentally, the servicing income that comes into books as per the above method is only the normal servicing fee.

**Will the unwinding of servicing asset be affected by implications of Ind AS 115- Revenue of Contracts from Customers?**

The objective of Ind AS 115 is to lay down principles that an entity should apply to report useful information to financial statement users regarding nature, amount, timing and uncertainty of revenue and cash flows from a contract with customer.
However, the application of this standard does not extend to financial instruments and other contractual rights/obligations within the scope of Ind AS 109.

For reference, the extract is presented below:

5. **An entity shall apply this Standard to all contracts with customers, except the following:**

   Xxx

   (c) **financial instruments and other contractual rights or obligations within the scope of Ind AS 109, Financial Instruments, Ind AS 110, Consolidated Financial Statements, Ind AS 111, Joint Arrangements, Ind AS 27, Separate Financial Statements and Ind AS 28, Investments in Associates and Joint Ventures; and**

   Xxx

Thus, as securitization and its inherent servicing asset and servicing liability is covered under Ind AS 109, Revenue recognition as per Ind AS 115 does not apply to it.

**Conclusion**

Servicing asset or liability is a by-product of the process of securitization. When the servicing facility is retained by the originator, he does that in exchange of a servicing fee. Now comparison of the actual servicing fee with the expected servicing fee charged normally, gives rise to a servicing asset or liability. Servicing obligation becomes servicing liability and servicing right becomes servicing asset. The carve-out from the larger financial asset and its split accounting is discussed at length above.
Global securitisation market

State of the Global Securitization Market

The memories of the 2007 credit crisis seem to gradually fade into oblivion, as the global securitization market hit the trillion dollar mark in 2018. The past year showed good activity with double digit growth on a year-on-year basis. U.S., China, Japan and Europe showed growth in volumes while issuance sank in Latin America and Australia. Subsequent to the crisis, the securitization market globally had been dead. Investors’ confidence eroded and securitization was tagged as too complex for market players.

Yet just over 10 years later, data shows that the structured transactions have hit the $1 trillion mark on a global level with last year as one of the most active yet. The conjoined efforts of regulators and international organizations had emphatically supported the revival of securitization. In 2013-14 there was a substantial pick-up in the investors’ interest and the momentum has continued both in terms of volumes and in terms of the credit performance. Even though the market is recovering, a lot of securitization is affected by the recession in European countries and turbulence in China’s financial system as growth is largely dependent on the economic and regulatory developments specific to the country.

Figure 5 shows the issuance volumes over the past few years across different regions:

![Historical Securitization Issuance](source: AFME Securitization Data Report, Value in € Billions)
Figure 5 provides perspective about the regional proportion of the global securitization market and its scale. USA has been dominating the global scenario although the volume has fallen since the 2008 crisis. Post crisis, the regulations became scrupulous globally, forcing originators to put in risk retention criteria.

Going forward, the securitization market issuance seems promising with expected issuance of over $520 Billion from USA. The Chinese market is also booming recording $292 billion in the past year with an expected issuance of $300 Billion as the market strides towards innovation in 2019. Europe, with consistent issuance over the years expects around $80 billion in total issuance. The global market’s reach of the $1 Trillion is paving the way for the structured finance market of becoming a prominent juncture in finance.

It is apparent from Figure 5 that over the years the U.S. has been the pioneer in securitization issuances. There was a substantial dip in the issuances volumes during the crisis, however securitization volumes have picked up in the past few years. The following is a pie-chart representation of the total securitization volumes by region.

![Pie Chart: % Share by Volume in 2018]

<table>
<thead>
<tr>
<th>Region</th>
<th>% Share by Volume in 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S</td>
<td>11%</td>
</tr>
<tr>
<td>Europe</td>
<td>35%</td>
</tr>
<tr>
<td>Asia/Pacific</td>
<td>51%</td>
</tr>
<tr>
<td>Canada</td>
<td>2%</td>
</tr>
<tr>
<td>Latin America</td>
<td>1%</td>
</tr>
</tbody>
</table>

Figure 6: Percentage share by volume in 2018
Source: AFME Securitization Report

In 2018, €106 billion of securitized product was issued in Europe, an increase of 29.2% from 2017 and an increase of 30.8% 2016. The aforesaid volumes have been derived at after taking together various
issuances under different asset classes such as asset-backed securities (ABS), collateralized debt obligations/collateralized loan obligations (CDOs/CLOs), commercial mortgage-backed securities (CMBS), and residential mortgage-back securities (RMBS). The following charts (3&4) show a comparison of the no. of deals and deal values of the last couple of years and worldwide ABS issuance, one of the most common asset classes:

**No. of Deals and Deal Values**

![Chart showing the number of deals vs deal values](image)

Source: S&P Global

**WorldWide ABS Issuance**

<table>
<thead>
<tr>
<th>Year-to-date volume ($)</th>
<th>2019</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Public</td>
<td>35.4</td>
<td>30.7</td>
</tr>
<tr>
<td>US 144A</td>
<td>62.3</td>
<td>65.6</td>
</tr>
<tr>
<td>Non-US</td>
<td>26.4</td>
<td>36.6</td>
</tr>
<tr>
<td>TOTAL</td>
<td>124.1</td>
<td>132.9</td>
</tr>
</tbody>
</table>

![Worldwide ABS issuance chart](image)

Figure 7: No. of Deals vs Deal Values
Source: S&P Global

Figure 8: Worldwide ABS issuance
Global Laws – At a glance

The legal and regulatory environments of countries have a direct impact on their volumes of securitization or as a matter of fact any financial transaction. And rightly so given the complexities and volumes of transactions. Red tapes and disputed laws tend to dis-incentivize investor acceptance, program establishment and sometimes also lead to costly diseconomies. An example is the RMBS sector in Canada. The following table (Table 1) is a brief for further reference in securitization laws around the world.

<table>
<thead>
<tr>
<th>Name of Country</th>
<th>Reference Link</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>Monetary Authority of Singapore (MAS) Guidelines on Securitization (The guidelines were finalized in 2000)</td>
</tr>
<tr>
<td>Australia</td>
<td>Australian Prudential Standard (APS) 120 made under section 11AF of the Banking Act 1959 (the Banking Act) By Australian Prudential Regulation Authority</td>
</tr>
<tr>
<td></td>
<td>Covered Bonds issued under Part II, Division 3A of the Banking Act 1959 (Cth)</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Bank Indonesia Regulation No. 7/4/PBI/2005 Prudential Principles in Asset Securitization for Commercial Banks</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>There is no specific legislative regime for securitization. Securitization is subject to various Hong Kong laws, depending on the transaction structure, transaction parties, underlying assets, and the nature of the offering of the securities.</td>
</tr>
<tr>
<td>Canada</td>
<td>Guideline on Capital Adequacy Requirements</td>
</tr>
<tr>
<td>European Union:</td>
<td>Regulation (EU) 2017/2402 (the Securitization Regulation) as on January 1, 2019</td>
</tr>
<tr>
<td>(UK, Germany, France, Italy, Sweden, Poland, Spain, Greece, Finland, Malta)</td>
<td>Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017</td>
</tr>
<tr>
<td>Country</td>
<td>Law/Regulation</td>
</tr>
<tr>
<td>--------------</td>
<td>--------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Italy</td>
<td>Law 130 of 30 April 1999, Italian securitization law (refer EU for latest law)</td>
</tr>
<tr>
<td>Greece</td>
<td>GREEK LAW 3156/2003 (refer EU for latest applicable law)</td>
</tr>
<tr>
<td>Japan</td>
<td>Securitization in Japan is governed by laws and regulations applicable to specific types of transactions such as the Civil Code (Law No. 89, 1896), the Trust Act (Law No. 108, 2006) and the Financial Instruments and Exchange Law (Law No. 25, 1948) (FIEL).</td>
</tr>
<tr>
<td>China</td>
<td>Administrative Rules for Pilot Securitization of Credit Assets (the Administrative Rules) on April 2005</td>
</tr>
<tr>
<td>Ireland</td>
<td>European Union (General Framework For Securitization And Specific Framework For Simple, Transparent And Standardized Securitization) Regulations 2018 (Central Bank of Ireland)</td>
</tr>
<tr>
<td>South Africa</td>
<td>In South Africa, securitizations are regulated according to the securitization regulations issued under the Banks Act 94 of 1990 (the Banks Act) Government Gazette 30628 of 1 January 2008 (Securitization Regulations)</td>
</tr>
<tr>
<td>Morocco</td>
<td>Law No. 33-06 on Securitization (Draft amendment of Law on Securitization)</td>
</tr>
</tbody>
</table>

Table 3: Global Laws at a glance

State of securitization in the United States of America

The United States of America is the largest securitization market in the World. In terms of depth, it is the only market in the World where securitization market draws participation from both institutional as well as individual investors. In terms of width, the US market has far more applications of securitization than any other market.

More than 50% of the global volumes in securitization originated from the USA. This by itself indicates the tremendous significance of USA in global securitization market. Not only this, even securitization issues
originating from other countries, including Japan, Europe and some of the emerging markets, draw investors from the USA. They continue to build on the robust performance displayed during the past years and registered a 36.72% year-on-year (‘16-‘17) and a lowly 4% (‘17- ‘18) growth.

U.S. issuance in volumes increased 4% in 2018. Auto issuance was up by 12% to $81.7 billion from $73.1 billion in 2017. While commercial ABS’s consisting of equipment, fleet lease and floorplan issuance summed to approximately $30 billion almost as same as 2017. Similar volumes are expected in 2019 as well. However several sectors showed declining roles in 2017. Some of them are discussed as follows:

U.S. Auto lease ABS volumes experienced near flat growth in 2018, increasing less than 1% at $15.9 billion. Two big captive finance issuers, BMW and Nissan issued only a deal each whereas historically they’ve issued two. Tesla, a new entrant into the market offset the decline with two deals totalling $1.4 billion. Volumes in the credit card ABS also dipped to $36 billion in 2018 compared to $47 billion in 2017. Widening spreads are attributed as possible reason for this slump. The personal loan ABS issuance was fairly stable at $12 billion and the S&P global expects similar volumes in 2019. With strong credit quality in the loan pool and amid good loan performance, the annual ABS for student loans increased to round about $18 billion. Chart 5 summarizes and compares the proportion of asset classes and their respective backing (agency or non-agency). Whereas Chart 7 shows the proportion of asset class issuances on a quarter-by-quarter basis of the last two years.
The CMBS market has worked through a maturity wall, and recent tighter pricing should help keep 2019 issuance steady.

Tighter spreads and the search for yield seems to be a global trend that has many investors comparing global ABS returns and frequently reaching into the higher-yielding U.S. structured finance market for non-traditional ABS products such as aircraft, container, solar and whole business deals. The concept of solar energy financing has been gaining traction in the U.S. and crossed the $1 billion in 2017. 2018 set a record with roughly $130 billion in new CLO issuances and almost $160 billion in refinances. Given this record high, we can expect a decline in 2019 as volumes are unlikely to sustain at such levels. Although upgrades of CLOs tend to outpace downgrades, the no. of upgrades seem to come down over the years as indicated in Chart 6.
State of Securitization in Europe

Being the second biggest market in the global scenario, Europe has over-performed last year by nearly 30% with more than €100 billion in volumes. However, due to the introduction of the new regulatory regime, volumes may shrink in 2019. Most of the recent growth in Europe’s securitization market can be attributed to the CLO sector where 2018 volumes were up by 40%. Part of this surge is due to U.S. managers issuing debut transactions backed by European collateral, taking cover of vibrant market conditions. A snapshot of the securitization by region is given below in Chart 8:
The EU’s new Securitization Regulation (i.e., the STS initiative) has now passed through the legislative process, along with associated changes to rules for determining banks’ regulatory capital charges on securitization exposures. These developments are unlikely to significantly boost volumes in 2019. Monetary policy has also significantly affected supply and demand dynamics in the European structured finance market through central banks’ asset purchases and provision of low-cost bank funding. Another factor that has contributed to higher volumes in the past year is front-loading. Issuers wary of the new regulations in effect from 2019 have been incentivized to bring transactions to the market ahead of January 1.

Given recent improvements in the economic outlook, we expect aggregate European structured finance credit performance to be positive in 2018. The default rate will likely remain somewhat elevated from the pre-2008 timeframe but below 1% and therefore below its long-term average.
State of securitization in Australia

The Australian securitization market is dominated by residential mortgage backed securities contributing to around 87% of the total issuance. Rest are CMBS, ABS and CDO contributing to a miniscule portion. Refer to the graph below:

The Australian securitization market saw a sharp decline in growth as volumes shrank from €29.2 billion from 2017 to €19.5 billion in 2018. The main reason for this downturn was due to a slow housing credit growth (less than 5%) as regulatory limits and interest only lending across the authorised deposit institutions sustained their effect. Given the relatively short weighted-average life of auto loan ABS transactions, we believe they have decreased transactional exposure to prevailing economic conditions compared with other securitized asset classes, such as residential mortgage-backed securities (RMBS). The Australian RMBS sector has sustained its good performance with low arrears, losses and loan-to-value ratios. Property prices have declined from their previous highs and slowly moderating due to tightening in lending standards and other macro measures which has constrained credit to some borrowers. Apart from RMBS, issuance of ABS had also dropped. Strong collateral performance evidenced by low levels of losses and arrears are a case in point. Recently, the Australian government announced an AUD 2 billion fund to invest in the securitization market to provide funding to smaller banks and non-banking lenders. Chart 10 compares the issuance volumes across asset classes between 2017 and 2018 in Australia.
Given the slowdown in housing credit from the Authorized Depository Institutions (ADI), non-bank originators have and will continue to capitalize on these lending opportunities. Additionally, offshore investors searching for attractive yields have also shown interest in this asset class given its historical record of strong credit and ratings performance.

**Volumes by Asset Classes**

![Figure 14: Volumes by Asset Classes](source: AFME, Values in € Billions)

**State of securitization in China**

Securitization in China started with a pilot program in 2005 allowing banks to securitize their loans. The 2008 crisis shelved the pilot program but was later restarted in 2012. However China’s securitization market has already touched the pre-crisis era levels as new issuances in Q2 2018 amounted to $103 billion. New issuance in China reached RMBI 2000 Billion (USD 297 billion) in 2018 up by more than 33% since 2017 (Refer to Chart 11). The spike was driven by strong RMBS issuance, securitization of corporate receivables and further propelled by unflinching demand for auto loan ABS. China continues to face many challenges. Primary concerns being reduced liquidity due to policy driven credit adjustments, uncertainty from the ongoing trade tensions with the U.S. and the rate hike environment outside of China. These macro-economic factors could certainly have a negative effect on the pro-cyclical industries subsequently affecting securitization. However, surprisingly asset performance has been stable in the securitization transactions in the past year. Except for some limited
cases of stress originating due to servicer transition, missed interest payments and originator failures, retail securitization in China continued to showcase robust performance. Rising household incomes, shorter loan tenures, stable employment and the amortizing nature of the loans support the much required good debt serviceability. The S&P expects an approximate 10% increase in securitization in China in 2019. Increasing investor acceptance and the eagerness of Commercial Banks to adjust their balance sheets are expected to act as the primary drivers of growth.

Figure 15: China’s Structured Finance Issuance
Source: S&P Global

<table>
<thead>
<tr>
<th>Assets</th>
<th>2017 (CNY Bil. $)</th>
<th>2018 (CNY Bil. $)</th>
<th>2019 Forecast (CNY Bil. $)</th>
</tr>
</thead>
<tbody>
<tr>
<td>RMBS</td>
<td>170.8</td>
<td>584.3</td>
<td>600.0</td>
</tr>
<tr>
<td>Auto Loan ABS</td>
<td>109.5</td>
<td>121.6</td>
<td>150.0</td>
</tr>
<tr>
<td>Credit Card</td>
<td>131.0</td>
<td>78.8</td>
<td>100.0</td>
</tr>
<tr>
<td>Other Consumer</td>
<td>310.6</td>
<td>203.7</td>
<td>200.0</td>
</tr>
</tbody>
</table>

Table 4: China Issuance Summary
Source: S&P Global

State of securitization in Canada
Given the country’s strong economic fundamentals it is no surprise that the market for structured finance has continued to improve in 2018. Transaction volumes stand at C$23.8 billion as of November 2018, recording a 19% growth from 2017. The volumes have been driven by mostly by credit card and auto-mobile ABS’s. The one sector in which Canada lags is the RMBS sector where volumes continues to be and is expected to be low due to issues like investor acceptance and costly diseconomies.

The securitization market is dominated by credit card, automotive and equipment receivables securitizations. Commercial mortgage-backed securities (CMBS), structured notes and private placements have staged a comeback from largely disappearing during the 2014-2015 period. The regulatory scene in the Canadian securitization market has been tightening enough to prevent financial bubbles but not enough to discourage the use of securitization and structured finance technology in debt financings. Overall, high quality collaterals, stable consumer behaviour and conservative lending practices is expected to propel ABS transactions in Canada in 2019.

![Figure 16: Canadian Structure Finance Issuance](source: S&P Global)
State of securitization in Japan

Japan recorded an approximate $55.3 billion of transaction in 2018, a 10% growth from 2017. The two main asset classes in securitization transactions in Japan are Residential MBS and ABS. These two asset classes account for almost 95% of the total issuance. Within the ABS sector auto ABS and other consumer ABS are the primary sub-asset classes. The strength of the securitization market in Japan is backed by low level of unemployment which will keep default rates and delinquencies for loans backing ABS and RMBS low. However, the Central Bank of Japan adopts a very low interest rate policy, which has enabled many corporations to raise funds without resorting to securitization. In March 2016, Japan Finance Corporation (JFC) had launched a synthetic CLO for the first time in five years. The synthetic CLO, with nine regional banks being the originating banks, had SME loans originated by the banks as reference obligations.

The volumes for 2019 are expected to increase with stable rating performances. However, headwinds such as the U.S.-China trade dispute and the government’s plan to hike consumption tax may impede growth.

Global Innovative Structures

1) Bayfront Infrastructure Capital Pte. Ltd. – Infrastructure project securitization (Singapore, Malaysia)65

Originator: Bayfront Infrastructure Capital Pte. Ltd. (BFIC)

Collateral: Project and Infrastructure loans diversified across 16 countries and 8 industry sub-sectors.

Highlight: First Infrastructure project finance securitization in Asia

Total Deal Volume: US$ 458 mil

<table>
<thead>
<tr>
<th>Tranches</th>
<th>Amount (US$ million)</th>
<th>Ratings `(Moody's)</th>
<th>Maturity Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>320.6</td>
<td>Aaa (sf)</td>
<td>11-Jan-2038</td>
</tr>
<tr>
<td>B</td>
<td>72.6</td>
<td>Aa3 (sf)</td>
<td>11-Jan-2038</td>
</tr>
<tr>
<td>C</td>
<td>19.0</td>
<td>Baa3 (sf)</td>
<td>11-Jan-2038</td>
</tr>
<tr>
<td>Subordinated</td>
<td>45.8</td>
<td>Not rated</td>
<td>11-Jan-2038</td>
</tr>
</tbody>
</table>

Credit Enhancement: 38% of the loan through MFI and ECA

Key features of the transaction:
a) 67% of the total loan value stems from five countries namely: Australia, Indonesia, Vietnam, Oman & Mongolia with the primary share of loans rooted in Australia (~20%).

b) The following pie shows the Sector categorisation of the portfolio:

c) The Expected Weighted Average Life of the transaction is 5.4 years with the Weighted Average Spread of 2.5%.
2) Jianyuan 2018-11 residential mortgage-backed securities

**Originator:** China Construction Bank  
**Collateral:** Residential Mortgages  
**Highlight:** The Deal marked the first time that any of the three biggest international Agencies had assigned a triple-A rating to an onshore Chinese RMBS transaction.  
**Total Deal Volume:** 9964.6 (mil. RMB) (inclusive of subordinated offering)

<table>
<thead>
<tr>
<th>Tranche</th>
<th>Rating (CBR/CCXI)</th>
<th>Issuance Amount (RMB in millions)</th>
<th>Expected Maturity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class A-1 Notes</td>
<td>AAAsf/AAAsf</td>
<td>1500</td>
<td>26/04/2049</td>
</tr>
<tr>
<td>Class A-2 Notes</td>
<td>AAAsf/AAAsf</td>
<td>1800</td>
<td>26/04/2049</td>
</tr>
<tr>
<td>Class A-3 Notes</td>
<td>AAAsf/AAAsf</td>
<td>5400</td>
<td>26/04/2049</td>
</tr>
<tr>
<td>Subordinated</td>
<td>AAAsf/AAAsf</td>
<td>1264.589717</td>
<td>26/04/2049</td>
</tr>
</tbody>
</table>

**Transaction Structure:**

**Credit Enhancement:** Tranching Design (Note Subordination)  
**Key Features of this Transaction:** The class 3 notes consisted of the major part, comprising over 54% of the offering. The repayment method for tranches A1 & A2 were scheduled amortization and Pass- through for A3.