Legal Research on

Structured Finance

A compendium of shortlisted articles submitted for the

Wadia Ghandy Award for Structured Finance Research

Covering articles on:

- *Bankruptcy remoteness in Indian securitisation/DA transactions - Whether the rules in India, particularly under IBC, clearly exclude third party assets and cashflows, and therefore, we do not have concerns on true sale in India? Whether it is still open for a creditor, claimant or IP to contend that the transaction of assignment is not a true sale at all, and therefore, the asset or cashflows do not become third party asset/cashflows? The question of true sale examined in light of global principles, and Indian law/regulations.*
- *Covered bonds and potential for structuring transactions of dual recourse in India. European Secured Notes structure and potential for using similar structures in India*
- *Legality of credit risk transfer arrangements in India in light of the prohibition on synthetic securitisation under SSA Directions.*

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Foreword

Wadia Ghandy & Co. (WG) has always been involved in the structured finance space and I personally have been working on this space for the last 16 years. Therefore, as soon as Indian Securitisation Foundation (ISF) announced a legal research competition in the field of structured finance, along with their annual Securitisation Summit, WG volunteered to be the sponsor for the competition.

I hope that the inaugural edition of this competition establishes a platform (which is continued in the years ahead) that celebrates the intersection of law and finance in the dynamic field of structured finance and that it serves as a catalyst for innovative thinking and in-depth analysis of the legal frameworks that underpin this complex and rapidly evolving domain.

As lawyers, we have an obligation towards the society and amidst the pressures of delivering for our corporate clients, we sometimes ignore or give step-motherly treatment to our societal obligations. One of our obligations is to foster and develop amongst students an interest in fields of law which are nuanced and complicated and I cannot think of a better way to discharge this obligation, than to sponsor such an award.

The topics which were chosen for this competition, represent a wide range in the structured finance space and covers some of the topics, such as bankruptcy remoteness, which is the core of structured finance. I am sure it provided the participants with a unique opportunity to delve into the multifaceted legal aspects of structured finance and explore a range of topics, including regulatory frameworks, contractual arrangements, risk management techniques, and legal challenges arising from innovative financial instruments.

I have been informed that despite being the inaugural edition, there was a good response to the call for papers and while only 3 are awarded prizes and only 10 features in this compendium, there were many who could have been made part of this publication if we did not have a limit on space.

Congratulations to everyone whose paper is a part of this list and I hope the readers enjoy reading this, as much as I did.

Nihas Basheer
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15th May 2023
Mumbai

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Squinting on the true sale doctrine in Indian securitization transactions through a US-India analysis

A case for reform

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This paper aims to analyze the true sale doctrine in securitization transactions in light of global approaches in bankruptcy law. In a securitization transaction, the originator transfers their receivables to a special purpose vehicle herein referred to as an 'SPV' via a 'true sale'. The SPV then proceeds to create a security, backed by the receivables of the originator and sells it to investors for cash which is then transferred to the originator for immediate liquidity requirement. The investors in turn are paid interests on the securities. However, problems arise in cases of bankruptcy of the originator which effectively pits two different parties of competing interests against each other; The creditors (of the originators) and the investors (who buy the securities). If the SPV owns the receivables, the investors shall continue to be repaid and if it doesn't, investor rights are subject to suspension. This 'ownership' of receivables is contingent on whether a 'true sale' of the receivables was operationalized. A true sale thereby isolates the assets from the bankruptcy of the originator by a transfer of ownership from the Originator to SPV herein referred to as "bankruptcy remoteness". Different jurisdictions have various statutes and factor-based approaches to determination of the "true sale "doctrine. This paper shall function as a comparative analysis of the "true sale" doctrine and provide critique as well as clarity for the same by highlighting jurisdictional inconsistencies and suggest policy measures that developing countries, such as India should undertake for a better securitization regime. In doing so it highlights three approaches to true sale determination namely: "factor-based approach", 'Statutory approach" and "property-based approach". The paper finally demonstrates why the factor-based must be swapped with either of the latter.

I. Introduction – Understanding Securitization & the "true sale doctrine"

The year 2008 is etched in human history as the year of the "great financial crisis", often also referred to as the subprime mortgage crisis. The story has been told numerous times therefore a retelling is futile. However, a closer inspection of the "financial" part of the crisis reveals a complicated but equally fascinating financial instrument: "mortgage/asset backed securities" issued through a process called "securitization". The concept emerged in the US in the 1970's as a machinery to convert loans to multifarious borrowers into cash flows for the lender. Some scholars blame securitization to be the epicenter of the crisis[1] however other scholars would rather lay the blame on lenders for issuing subprime loans without due diligence. The debate only goes to show how deep and pervasive securitization has become to global economies.

[1] Eggert. Kurt, 'The Great Collapse: How Securitization Caused the Subprime Meltdown' *Connecticut Law Review.* 27, 2009

The 2008 crisis was driven by "mortgage-backed securities" or "asset backed securities" which as a term, I'm sure the reader must have come across while reading any opinion piece on the crisis. Asset backed securities are issued through a process of securitization. To understand this process, assume a hypothetical company called "*Carsondemand*" (originator). The company is engaged in the business of leasing cars to customers for a fixed price paid monthly (receivables). Due to a reduction in petrol prices, the market of cars suddenly grew and *Carsondemand* needed immediate liquidity in cash to produce/procure more cars to meet the demand. The company requires instant credit however, full payment by its customers would only operationalize on a much later date after the finality of the lease. A loan from a bank would be disadvantageous given the high interest rates (funding costs). Hence, the company decides to raise funds through securitization. A separate trust ("an SPV") is created, and the company's receivables is sold to the trust. This it does so by transferring its rights of payment from those lease rentals (referred to as 'receivables') in a "true sale" to the trust. The trust in turn, pools in all the receivables and issues securities to capital market investors and uses the proceeds to pay for the receivables thereby transferring the cash to the company. This process is referred to as securitization. The benefits of securitization are plenty namely, conversion of future receivables to instant cash flows for the originator, bankruptcy remoteness of the assets, reduction in funding costs (high interests payable to lenders in traditional loans) and more. In the Indian context specifically, securitization is the only hope for much needed funding to resource starved sectors like the power sector and can facilitate fresh-asset origination in the housing sector by generating consistent cash flows through mortgage-backed securities.

However, problems in the securitization framework unravel during the bankruptcy of the Originator. Take the present instance. After a few years, *Carsondemand* declares itself to be bankrupt. As a general common law doctrine in bankruptcy law, the creditors can only stake a claim over the assets of the bankrupt party as long as the assets are in its ownership. Once the assets have been sold, the creditors' rights extinguish. Structured finance is based on precisely this doctrine; of bankruptcy remoteness; which refers to structurally isolating a group of assets and thus excluding them from the bankruptcy risk of the Originator.[2] Therefore, the creditors of *Carsondemand* would theoretically not be able to enforce any claim over the assets of the company. Investors undivided rights over the receivables would be categorically enforced at the expense of creditor claims. However, bankruptcy remoteness is contingent on this one principal axiom: That the sale of assets between *Carsondemand* and the trust was a "true sale". If such a sale has not been established, the courts re-characterize the transaction as a collateralized loan. In case it was found to be the latter, the assets of the Originator would be put under moratorium and therefore, the interests of the investors shall perish.

Different jurisdictions have different criteria for deciding whether a sale constitutes a "true sale" or not. A statute-based approach, factors-based approach or more recently in academic circles, a property-based approach are the three ways or deciding the same. Notwithstanding the true sale, sometimes the courts may lift the corporate veil and even consider the SPV to be a mere subset of the originator and thereby consolidate the assets.[3] This however can easily be avoided by ensuring proper contractual terms which make sure the other assets of the originator are not-co mingled with those of the SPV. Additionally, having separate accounts for the assets and ensuring enough capitalizing for the SPV are but some ways to avoid consolidation.

Reverting back to the "true sale doctrine" some jurisdictions like that of the US have a statute based approach by inserting "safe harbour" provisions for true sales in their bankruptcy code whereas others

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[2] Cohn, Michael J. "Asset Securitization: How Remote Is Bankruptcy Remote?," *Hofstra Law Review: Vol. 26: Iss. 4, Article 4,* 1998 Available at: http://scholarlycommons.law.hofstra.edu/hlr/vol26/iss4/4

[3] Vinod Kothari, 'Securitisation' *Academy of Financial Services, Y2K ed*. at 30-3, November, 1999.

like that of my home country India, have a factors based approach where the determination of a true sale is done on a case to case basis considering various factors such as the intention of the parties a fair market price of receivables, extent of recourse to the Originator and the extent of transference of risk. The extent of weightage given to each of these criteria is not well settled, however. Such is the problem of the factors approach. This, as shall be argued later, gives tremendous judicial discretion to courts leading to higher judicial uncertainty and conversely, lower investor confidence.

The factors-based approach considers certain factors in determining what constitutes a “true sale”. The following are but some of the important factors:

a. Fair Market Price: The Price at which the SPV buys assets from the originator should be a fair market price. In case it is not so, the courts may consolidate the assets of the Originator and the SPV.
b. Recourse: If the originator retains a certain risk of loss while transferring its assets to the SPV, a strong case can be made to re-characterize the deal as a collateralized loan instead of a “true sale” thus destroying the bankruptcy remoteness of the transaction.
c. Separation: The SPV must be a separate legal entity from that of the originator. The court will look at whether the affairs of the SPV and the originator are excessively entangled. [4]
d. Intention of the parties: The intention of the parties can either be inferred from the actual terminology of the transactions, the structure and T&C of contracts. There is plenty of judicial uncertainty as to how the intention of the parties are to be engendered leading to judicial uncertainty. [5]

The factors approach led to a slew of contradictory judgements in the US leading to a goliath cloud of judicial uncertainty over securitization transactions leading to a fall in investor confidence. The US case study will be explained in section II alongside its Indian counterpart. India is on track to use the same factor-based approach by legislating the same. US ultimately forgo the Factors based approach by passing the Bankruptcy reform bill wherein it inserted an explicit “safe harbour provision” in its Bankruptcy law reform bill to combat the judicial uncertainty, the factors-based approach engendered. Another alternative, “Property Law based approach” has been recommended by various scholars exalting the need for reform in the true sale doctrine which shall be explored briefly in section III. The paper argues that India can benefit from swapping the factor-based approach to a “statutory approach” or a “property law” based approach as shall be argued further.

The next section shall juxtapose the development of Factors based approach in India and US and argue how India can benefit from swapping the factors approach with the statutory safe harbor approach.

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[4] Jeffery E. Bjork, ‘Seeking Predictability In Bankruptcy: An Alternative to Judicial Recharacterization in Structured Financing, available at http://www.law.emory.edu/ BDJ/volumes/fal197/bjork.html.

[5] See, *Major Furniture Mart v. Castle Credit Corp* 602 F. 2d 538 (3d Cir. 1979) where the court ignored the terminology of the contract and relied on the strcutre and T&C of the contract. Also see, *Cohen v. Army Moral Support Fund,* 67 B.R. 557 (Bankr. D.N.J. 1986). where the court took into account the implied intention of the parties by the wordings of the contract rather than looking at T&C’s

II. India-US: how different jurisdictions deal with the doctrine of True Sale

Given that India is my home country, I feel it fit to begin this section by reflecting on the Indian experience with regards to the "True sale doctrine". The effect of the 2008 crisis was felt world over. India's GDP growth rate, which had been over 9 percent for three years up to 2007-2008 came down suddenly to 6.7% in 2008-2009.[6] This prompted the RBI to regulate securitization in India. Prior to these regulations, India primarily used different legislations such as the Transfer of Property Act, SARFAESI etc in combination with a factor-based approach. However, with regards to the Property act, the unanswered question of whether future receivables would be treated as "future property" under transfer of property act, 1882 had led to a cloud of uncertainty over the securitization regime in India. Improving upon this property-based approach applied in conjunction with the new Insolvency and Bankruptcy code 2016 was indeed the correct approach to the "true sale doctrine" given that India already had a good property law regime to effectuate the same. Under section 5 of the Transfer of Property Act, 1882, the conveyance or transfer of future property is dealt with as an executory contract enforceable as soon as the future property comes into existence. [7] In her paper, Gauri N. Walawalker argued that the property act, by effectively distinguishing between "future interest" and "future property" effectively accorded a stronger basis to bankruptcy remoteness of securitization transactions. [8] Furthermore, the words *shall vest* in section 5(1) of the act read with section 5(1) ensures that the bankruptcy of the originator will not reduce the status of the security holders to that of unsecured creditors.[9] Transfer of property act, read in line with that of the Insolvency and Bankruptcy code provides a holistic statutory framework for securitization transactions. One of the key goals of the IBC as mentioned in its preamble is that it ought to balance the interests of the stakeholders. This it achieves beautifully in case of securitization transactions. It implicitly ensures the rights of investors and bankruptcy remoteness of the SPV by not explicitly declaring such transfers to be invalid however at the same time it does not leave the creditors of the originator in the dark when the transfer or transactions is fraudulent[10]. Hence, a property law-based approach could well have worked for India.

Instead, India decided to opt for the Factors based approach probably due to the fact that neither the TOPA nor IBC explicitly mentioned or defines "true sale". The factors based approach was thereby legislated in the 2006 Guidelines on securitization by RBI. Pointers 7.1 to 7.15 engendered the factors based approach in the said guidelines. This approach was later crystallized in the 2012 guidelines[11]. The ultimate result of this was as predicted, judicial uncertainty. A final wake up call to the central government, regarding judicial uncertainty and the abject state of securitization in India was after the much talked about case of Dewan Industries by Bombay High Court which created a cyclone in the domestic securitization regime. The decision led to a slew of responses from various stakeholders. The securitized instruments and loans were originated and serviced by Dewan Housing Finance Corporation. With Dewan Housing being referred to Insolvency proceedings, questions arose as to whether the moratorium imposed on the assets of the debtor under Section 14 of the IBC would be

[6] Basu. Kaushik, An economist in the real world: The art of policymaking in India, *Penguin Books India*, 2016

[7] Jugalkishore v. Ram Cotton Company, 1955 AIR 376

[8] Gauri N. Walawalkar, 'Securitisation: Bankruptcy Remoteness and Other Issues', 2 *LAW REV. GOV't* L.C. 206 (2002-2003).

[9] Ibid

[10] Insolvency and Bankruptcy code 2016, s. 66

[11] Reserve Bank of India, Revisions to the guidelines on securitization transactions, May 07 2012, pg 21-22, https://rbidocs.rbi.org.in/rdocs/notification/PDFs/FIGUSE070512.pdf accessed 2nd May, 2023
See also, Reserve Bank of India, Revisions to the guidelines on securitization transactions, August 21 2012, pg 17-18, https://rbidocs.rbi.org.in/rdocs/notification/PDFs/C170RG21082012.pdf accessed 2nd May 2023

applicable to securitized assets as well. This uncertainty caused a shockwave in the capital markets regime prompting criticisms from various stakeholders. CRISIL released a press release on October 22, 2019 asserting that due to the uncertainty by the judgements of Bombay High court, defaults were occurring due to incorrect interpretations.

A sole solution to this was a solid legislative framework for securitization that provided sanctity to all legal aspects of such transactions including the 'true sale" doctrine. Perhaps, adopting a safe harbour provision like the US instead of the factors-based approach could have been the answer.

Krishnan Sitaraman, Senior Director, CRISIL Ratings stated in the CRISIL report,

> *"If there is no immediate clarity on the legal standing of securitisation transactions in relation to the liquidation estate of originators / servicers, the ability of credit rating agencies to differentiate the credit quality of securitised instruments from their servicers and originators will be affected. That can significantly impact investor appetite for securitisation transactions, and potentially limit access to funding for non-banks through this route. It can also affect the government's recently announced partial credit guarantee scheme under which securitisation of Rs 1 lakh crore of assets is to be facilitated."*

In response to the shockwave, the government went into damage control and released the "FSP third party assets notification on dealing with third party assets in the custody or possession of financial service providers" ("FSP's") which are undergoing Insolvency proceedings under the Insolvency and Bankruptcy Code, 2016. The FSP Rules read with rule 10 of FSP third party assets notifications clarified explicitly that the no moratorium under section 14 of IBC will be imposed on third party assets in cases of securitisation. The notification bridged the gap between the definition of "true sale" under prevailing guidelines and what happens to the assets undergone true sale within the confines of IBC however remained mute on how these sales were to be characterised as "true sale". Therefore, Point 2.5 under the "guidelines on securitization transactions" released by RBI on 7 May 2012 and on 21 August 2012 which explicitly defined true sale transactions would continue to be the guiding statute on the determination of true sale.

a) The true sale should result in immediate legal separation of the Originator and the SPV
b) The assets so transferred should stand completely isolated from the Originator during its transfer to the buyer.
c) The Originator should transfer all risks, rewards, rights and obligations pertaining to the asset and shall not hold any beneficial interest in the asset after its sale.
d) The buyer should have unfettered rights of sale, transfer or exchange of the assets.
e) The buyers should have no recourse to the to the originator for any expenses or losses.
f) No obligations on originators to repurchase the assets.
g) Fair market price should be given in respect of sale of assets
h) The originator acting as the servicer would not detract the true sale nature of the transaction.

The above determinants were nothing but statutory recognition of the factors approach to determining true sale transactions. The factor approach provides a multitude of factors for the adjudication of whether a transaction is "true sale" or not. The court often has to determine which of these approaches hold more weight. The factors approach have been criticised by multiple scholars as confused, unsettled and subject to differing approaches from court to court.[12] Scholars such as Heather Hughes have called for a property law based true sale doctrine which is heavily grounded on a conception of Property that can justify and explain investors rights of exclusion against a company's unsecured creditors. Harris and Mooney, the academic founders of the property law approach to true sales argue that these factors

[12] Heather Hughes, 'Reforming the True-Sale Doctrine', 36 JREG BULLETIN 51 (2018-2019).

were not sufficient grounds for determining a deal. The same was recognised, albeit the hard way, by the United States.

The United States' experience with regards to Bankruptcy remoteness has been a process of learning from2 trial and error. Perhaps, a lot of errors. Initially, the United States fostered a factors based approach similar to the Indian way, in determining the "true sale" in a securitization transaction. This had predictably led to a slew of contradictory cases.

Prior to the Bankruptcy Reform Bill, Section 541[13] of the US Bankruptcy Code defined the property within the estate of debtor in Bankruptcy includes, "*all legal or equitable interests of the debtor in property as of the commencement of the case."* However, to determine the interests or property of the debtor or in other words, whether a sale would be considered a "true sale" or a collateralized loan, the courts were to look at federal state law for an answer. Even the Uniform Commercial Code, left the determination of whether transfer of payment intangibles were a sale or was for security to courts.[14] In a piercing read by Matthew W. and Jennifer M., the authors highlight the multitude of cases where the factors-based was applied and how the same led to contradictory ruling leading to no established principles for true sale.[15] Note here how the bankruptcy remoteness proved to be one of the key determinants of investor confidence, and leaving the same solely up to the courts adversely affected the same.

In the first case of *Major's Furniture Mart, Inc. v. Castle Credit Corp*, the court re-characterised the transaction as a loan based on the full recourse nature of the transaction as well as the originators retention of risk. In a similar case of *Endico Potatoes, Inc. v. CIT Group/Factoring, Inc*[16] the court while re-characterising the transaction as a loan relied at the agreement terms and noted that the language of the agreement clearly refers to the transaction as loan. In *Ratto v. Sims (In re Lendvest mortgage , Inc*)[17] the court indulged in a transference of risk analysis of the agreement and noted that "where the risk of loss is shifted from the investor to the debtor through a contractual guarantee of repayment by the debtor, the transaction is a loan and not a sale." However in the decision of Carter v. Four Seasons Funding Corporation[18] established that taking a little risk of ownership even if not a lot, can aid a buyer in concluding a true sale transaction. The court attributed the burden of proof to the seller to showcase that the transaction was not a true sale, by showing in clear terms that the transaction was a loan. None of these cases above showcase the intention of the parties as a primary determinant of true sale. One case however detracted and factored in the intention of parties as a primary determinant. In *Cohen v. Army Moral Support Fund (In re Bevill, Bressler & Schulman Asset Mgmt. Corp)* the trustee argued that repo rate and reverse repo rate transactions should be characterised as loan and not sale. The court disagreed and held that, under New York and New Jersey law, "the intent of the parties viewed in the context of the entire market in which these transactions take place is the controlling consideration" The court asserted that the "unequivocal" language of the agreement would be prima facie evidence that the agreement was a sale and not a loan.

One judgement however, similar in scale as the *Dewan Housing Industries case* in India sent shockwaves to the American securitization market. In the case of *LTV Steel Co.,* LTV had challenged its pre-bankruptcy securitization arguing that the transaction was not true sales. Therefore, LTV argued that it should be permitted to use the collections of receivables as "cash collaterals". What is appalling

[13] II U.S.C. §541.

[14] *See* Rev. U.C.C. § 9-318, cmt.2.

[15] Matthew W. & Jennifer M, 'Buyer Beware: An analysis of True sale issues', 1 Pratt's J. Bankr. L. 185 (2005)
[16] 67 F.3d 1063 (2d Cir. 1995).

[17] 119 B.R. 199 (B.A.P. 9th Cir. 1990).

[18] 97 S.W.3d 387 (Ark. 2003).

however, is that the only argument LTV posited was that without such cash use, the company would have to cease its operations and the same would jeopardize the jobs and retirement benefits of its employees and thus would harm the economy. The court, shockingly, allowed the petition and characterised the transaction as a loan and not a true sale. This, predictably so, shook investor confidence in financial markets. Contrary to the opinion of most, such a case was predictable given the inherent unpredictability of the factors based approach given the judicial discretion it accords to the courts.

I only need to adduce common sense to showcase that judicial discretion in cases of securitization is inversely proportional to investor confidence. The more uncertain the risks emanating from a transaction, the more it will hinder the investor's willingness to invest. [19] The US government, similar to that of the Indian government, went into damage control; however, the policy adopted by the US in response to the LTV case was different in degree and nature than its Indian counterpart. Instead of legislating the factors based approach, they realised the need to have parliamentary intervention to dissipate judicial uncertainty from the securitization regime. A bankruptcy reform act was drafted and President Bush signalled that he would put the same into law once both houses in congress reconcile their difference. The Bankruptcy Reform Act, among other things contained, for the first time, a legislative "safe harbour" for true sale transactions in Securitization transactions. It amended the same Section 541 of the American Bankruptcy Code[20], as discussed above, and categorically excluded any "eligible asset" transferred to any "eligible entity" in connection with an "asset backed securitization" from the estate of the debtor (or herein the originator). The definitions of "eligible assets" and "eligible entities" was defined in broad terms to include all receivables and any kind of legal SPV. After the enactment of the Bankruptcy reform bill, the factor approach was categorically eliminated i.e. the factors such as nature of recourse to the originator or whether the originator has retained any right to take bake receivables were simply extinguished from the mandate of the judiciary. Provisions securing the interests of the creditors of the originators in cases of fraudulent transfers were held intact under Section 548 of the Bankruptcy code.[21] This provision greatly mitigated the risk involved in factor approach and in doing so ensured that the LTV case doesn't repeat.

As can be observed from the American experience, they sought a statutory based approach by swapping the same with the factor approach. India on the other hand, merely legislated the factor based approach in its definition of a "true sale" under the guidelines on securitization transactions issued on 7 May 2012 and 21 August 2012. The approach of India is futile as it does not address the disease at its core, rather only addresses the symptoms. However, as Rafeal Diaz Grandos succinctly points out, the varying approaches to securitization flow from country specific cultural and legal backgrounds for securitization. [22] Hence, it would be incorrect to assume that India would be better off importing the policy of the US especially taking into account that the US is a developed nation and India is still enroute to being a developed nation. Creditor rights, especially those of unsecured creditors and equity-based case adjudication cannot totally be discounted. [23] However, if we are quick to learn from the American experience, at least to the extent of the negatives of the factors-based approach, we may be able to save at least some of the initial victims of unsettled judicial principles in Indian Securitization.

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[19] Guiso, Luigi, Sapienza, Paola, and Luigi Zingales, 2012. 'Trusting in the Stock Market,' *The Journal of Finance,* Vol. 63, No. 6, 2557-2600.

[20] 11 U.S.C. § 541 (2000).

[21] 11 U.S.V. § 548 (2000).

[22] Rafael Diaz-Granados, 'A comparative approach to securitization in the United States, Japan, Germany and France' *Willamette Bulletin of International Law and Policy,* 1996, Vol. 4, No. 1 (1996), pp. 1-26

[23] Lupica, L. R. 'Asset Securitization: The Unsecured Creditor's Perspective' *Tex. L. Rev.*, *76*, 595 (1997)

The next section provides a third approach to determination of "true sale" in a securitization transaction grounded in Property Law. This approach might be better suited to India given the country's holistic property law and established judicial doctrines within the same.

III. Property Based approach: An Indian alternative?

The property based approach was first theorised by Steven L. Harris & Charles W. Mooney in their paper When Is a Dog's Tail Not a Leg?: A Property-Based Methodology for Distinguishing Sales of Receivables from Security Interests That Secure an Obligation. I explicitly mention the title of the paper in addition to the citation to draw emphasis and exalt the reader to go through the paper given its succinctness, lucidity and brilliance. The authors argue that a true sale doctrine based on conception of property would be a better determinate of "true sale" than the factor based approach or even the "statutory approach" of the US. In addition to judicial certainty, the doctrine offers a moral justification of the investors right of exclusion as against a company's unsecured creditors. [24] It located the "true sales" determinacy within two doctrines in property law namely; Numerus Clauses and rights of exclusion. Several scholars have further affirmed the relevance of the doctrine such as Heather Hughes. [25] Harris and Mooney argue that the only determinant criteria to establish a true sale is whether the seller has retained an "economic interest" in the asset and whether the interest transferred to the purchaser secures and obligation. [26]. To establish this economic interest one must look to true lease agreement and apply a similar rationale to all transactions involving receivables. They argue that an "economic interest" must be seen parallel to "residual interests" in lease sales. Residual interest is referred to as the value of equipment at the end of the lease. An economic interest therefore, would be any retained rights of the seller to collect on receivables. Given the cohesive property law regime in India, especially the intersection between Transfer of Property Law, 1882 and the Insolvency and Bankruptcy code 2016, the "property law doctrine" has tremendous scope in India. How this approach turns out, would be predicated on the lawmakers and the courts. What is clear however, is that the factors based approach will likely lead to judicial uncertainty which is certain to affect investor confidence in securitized assets. Contrary to some scholars who discount the benefits and efficiency of securitization by arguing that it leads to inequity due to the distributional consequences of some parties being preferred over others,[27] gains from asset securitization are not just wealth appropriation by bond holders but benefit the economy by asset origination and servicing. [28] Therefore, a thriving securitization market is critical if India is to solve its NPA crisis and help its housing sector as well as provide much needed funding to sectors such as the power sector.

IV. Conclusion

Through this paper, the author has tried to demonstrate how the factor based approach in determining true sale of a securitization transaction has proven inadequacies in light of global trends. India, has to

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[24] *See* Steven L. Harris & Charles W. Mooney, Jr., 'When Is a Dog's Tail Not a Leg?: A Property-Based Methodology for Distinguishing Sales of Receivables from Security Interests That Secure an Obligation', *82 U. CN. L. REv. 1029* (2014)

[25] Heather Hughes, 'Property and the True-Sale Doctrine', 19 U. PA. J. Bus. L. 870 (2017).

[26] *Id. See Also,* Hughes Heather, 'Reforming the true sale doctrine' *Yale Journal on regulation Bulletin 51, 2019-2019*

[27] R. Lupica, 'Asset Securitization: The Unsecured creditor's perspective' (n 23) 659
[28] Thomas. Hugh, 'A primary look at gains from asset securitization' *Journal of International Financial Markets, Institutions & Money,* 9 (1999) 321–333

its peril, sought to legislate the factor based approach when faced with the negative consequences of such an approach, America however has taken a more efficient route and swapped the factor based approach with the statutory approach by creating a “safe harbour” for true sale transactions in its Bankruptcy code. In the absence of any such Safe Harbour in India, and the concerns regarding inequity, the author presents a third way of interpreting true sale transactions in India by a property law approach grounded in the Indian property law framework. Such an exercise would lead to a better securities market by boosting investor confidence.

Bankruptcy Remoteness in Indian Securitisation/ Direct Assignment Transactions

The question of true sale examined in light of global principles and Indian laws/ regulations

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An asset was sold by a company to a third party and now the Company is undergoing insolvency. The asset is claimed by the creditors/claimants/insolvency professional to be a part of the estate of the Corporate Debtor. Whether the claim can be justified?

One thing which all the stakeholders are concerned with when a company enters into insolvency is whether their interest in the company is secured and whether they would be repaid by the company. To address this question, a claim over the assets of the company is one of the most important things to be dealt with, as one which does not form part of the estate of the Corporate Debtor cannot be distributed amongst the claimants, because that asset did not belong to the Corporate Debtor at all in the first place at the time when the Corporate Debtor entered into the stage of insolvency.

It can be rightly put that where the question of money is involved, a dispute in some way or the other is bound to happen and to solve this dispute the role of legislation has been of a pivotal one. The paper deals with the issue hovering around the true sale of assets belonging to a Corporate Debtor and unfolds how the global principles and the Indian legislation deals with such an issue, especially in light of the newly enacted legislation, The Insolvency and Bankruptcy Code, 2016.

ABBREVIATIONS

CD	:	Corporate Debtor
CIRP	:	Corporate Insolvency Resolution Process
DA	:	Direct Assignment
FSP	:	Financial Service Providers
GAAP	:	Generally Accepted Accounting Principles
IBC	:	Insolvency and Bankruptcy Code
IP	:	Insolvency Professional
IRP	:	Interim Resolution Professional
PUFE	:	Preferential, Undervalued, Fraudulent or Extortionate
RBI	:	Reserve Bank of India
u/s	:	Under section

I. Introduction

One of the most important issues pertaining to any sale of an asset has been whether the sale was a true sale or not, and determining the answer to the question becomes very important, especially in cases of insolvency and bankruptcy. If the transaction is not a true sale, then the recovery rate shall be higher for the CD, thereby meaning that the creditors to the CD shall have to face a lesser amount of haircut.

In light of the rising concerns of lower recovery in bankruptcy cases, the need for determining whether a sale amounts to a true sale through appropriate rules and regulations surrounding it becomes important. This would enable to reflect a true and correct view of the recovery which is made, thereby instilling confidence in the economy of the business environment of India. If the legislation of an economy lays down the guidelines for determining these issues, there is greater recovery and promotion of ease of doing business, making that economy an attractive destination for investments. One must remember, it is not only the easy entry that counts but also the easy and effective exit that affects an investment decision.

Before proceeding with the main issue, it becomes imperative to understand some of the terminologies, because a thing misunderstood is more harmful than a thing not understood.

What exactly do we mean by bankruptcy remoteness?

In layman's term we can state that an asset belonging to a third party is said to be bankruptcy remote or an entity is said to be bankruptcy remote if such asset/entity is not affected due to the bankruptcy faced by a given entity. In other words, if a company 'X' goes into bankruptcy, the assets sold by X to a third party or an entity belonging to such company 'X' would be said to be bankruptcy remote if such asset or entity would not form part of the bankruptcy estate of the company 'X'.

What do Direct Assignment and securitisation transactions mean?

Direct assignment refers to the sale of receivables belonging to an entity to another entity thereby making the other entity the owner of the receivables. On the other hand, securitisation refers to the pooling of assets which are homogeneous in nature and then repackaging such assets pooled in the form of marketable securities, and then these securities are sold to the investors. In the case of securitisation, it is the securities that are purchased by multiple investors, while in the case of DA, it is the underlying asset that is being purchased by a single investor or a consortium of investors in certain cases.

What classifies an asset as third-party asset or what does third-party cash flow mean?

One can state an asset as a third-party asset if such asset at the time of insolvency/bankruptcy of an entity is in the custody of such entity either on account of trust or under any other contractual arrangements, but the entity is not the legal owner of such asset. Similar is the case for cash flows, whereby the cashflows in real are not of the entity but belong to such third party, and the amount is held by the entity on behalf of such third party.

What do we mean by a sale being termed a true sale?

The transaction to be termed as true sale needs to satisfy certain criteria as laid down under the US GAAP, which, *inter alia*, includes the following:

- "Legal isolation of the transferred assets, which places the assets beyond the reach of the transferor's creditors or a bankruptcy trustee for the transferor.

- The transferee's right to freely pledge or exchange the transferred assets.
- The transferor's relinquishment of effective control of the transferred assets.

If the transaction includes certain indicia of retained ownership, the intended transfer, if contested, could be recharacterized by a US court as a secured loan rather than a sale."[1]

It becomes of prime importance that a transaction of sale be classified as a true sale failing which it may so happen that the buyer of the asset may need to relinquish his/her ownership right over the asset in favour of the bankrupt entity, mainly because the transaction lacked the characteristics of a true sale, thereby meaning that the transaction was entered into so as to benefit the parties on or before the entity entering into bankruptcy.

II. Understanding the essentials of true sale

Asset identified, parties agreed upon, price determined and agreement of sale entered into. Now, the question which arises is whether the sale is, in fact, a true sale or a mere sham, a colourable exercise of powers by the parties, whereby they are actually entering into a loan agreement in the name of a sale transaction, and thus avoiding the risk of the asset being covered under the bankruptcy/liquidation estate. ***Read now to know more…***

There are certain tests that must be fulfilled so as to classify a transaction of sale as a true sale. If these tests are satisfied, the asset of the buyer would be termed as bankruptcy remote and hence would be safe from the chances of being brought under the purview of the bankruptcy or liquidation estate of the entity undergoing bankruptcy or liquidation.

Test to determine a sale as a true sale:

- *Risk and recourse* – If in a given sale, the seller transfers all the risks which are attached to that asset with no recourse to him, that is, the asset is transferred *in toto*, then the sale may be classified as a true sale. The greater the risk which is retained, the higher the chances that the sale may not be regarded as a true sale. Where the factor had full recourse on the seller, the transaction would amount to financing and not a sale.[2]
- *Repurchase by the seller* – If there is an option of repurchase by the seller of the asset, it would signify a conditional sale and weigh in favour of the transaction not reflecting a true sale unless proved otherwise.
- *Intention of the parties* – The form of the document though an important thing to look upon, but not the only thing. It is the substance which matters over the form of the transaction. It is necessary that the characteristics of a true sale are reflected by the intention of the parties.
- *Retention of control* – It may so happen that the seller sells the asset, but retains control over the asset sold. In such a scenario, the transaction cannot be termed as a true sale because the purchaser does not enjoy an exclusive right over the asset purchased.
- *Originator acting as a servicer* – Merely acting as a servicer of the asset in itself does not amount to vitiating the true sale unless and until backed by indemnity obligations on part of the servicer or any other such obligations.

[1] Glossary–True Sale, https://ca.practicallaw.thomsonreuters.com/w-023-5473?transitionType=Default&contextData=(sc.Default)&firstPage=true
[2] Major's Furniture, Inc. v. Castle Credit Corp., 602 F.2d 538 (3d Cir. 1979)

- *Understanding the agreement* – The rule of literal construction in interpretation of documents has been the rule governing determination of rights and obligations under all types of contracts unless it gives rise to ambiguity. The intention of entering into the transaction can be inferred from the language of the agreement which has been entered into. "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."[3]
- *Participation in surplus* – It may so happen that the seller adds a clause in the agreement entitling him/her to enjoy the benefits of the surplus which arises in the given sale, an amount over and above that what was expected. This may reflect that the transaction was in a sense a loan agreement with greater degree of safety in the form of non-recourse in cases of loss.
- *Payments irrespective of collections* – If the seller undertakes to pay an annuity or a fixed amount of money at regular intervals, whether or not the seller has received such amount from the obligor, then the transaction would not reflect a true sale.
- *Absolute transfer* – One of the most essential elements of any sale is that the sale to be binding must be absolute in nature, transferring all the rights and obligations attached. If the seller restricts the right to alienate the asset, then the sale cannot be said to be an absolute transfer, and hence not a true sale.
- *Consideration* – Consideration can be said to be one of the criteria which may vitiate a true sale, as a reasonable man is not expected to sell an asset that belongs to him at a price that is way below the market price.

The above list is indicative of the factors which may help to determine whether a sale is in fact a true sale, and the list cannot be said to be an exhaustive one. The Adjudicating Authorities take into consideration various factors to come to a conclusion with regards to true sale. Principles of balancing are applied to determine whether the transaction would amount to a sale or a financing. Just one factor in isolation cannot be considered. In Re Shoot the Moon case, the Court held the transaction to be not a true sale after considering various factors.[4]

Whether it is a trite law that the sale must be a true sale?

For a purchaser under a contract of sale to be protected from the risk of parting away with the asset in cases of bankruptcy/liquidation of an entity, it becomes very important that the sale be classified as a true sale. "*As per the Guidelines on Securitisation and Direct Assignment issued by the RBI, the isolation of assets or 'true sale' from the originator to the SPV is an essential prerequisite.*"[5]

If a transaction is not classified as a true sale, then it may alter the rights and obligations which exist under the sale as the sale may be held to be a secured loan.[6]

"*The Guidelines on Securitisation of Standard Assets dated 1 February 2006 ("Securitisation Guidelines") provides when an assignor transfers all risks and rewards and rights and obligations pertaining to assets to the assignee and is not liable to the assignee in any way with regard to the assets*

[3] Incorporated v Yun Choy Limited and the Standard Chartered Bank (Hong Kong) Limited, [2012] 1 HKLRD 3969
[4] Cap Call, LLC v. Foster (In re Shoot the Moon, LLC), 2020 WL 6588407 (Bankr. D. Mont. Nov. 6, 2020)
[5] Webinar on Assignment of Receivables, Vinod Kothari Consultants Pvt. Ltd. (09 April 2020), https://vinodkothari.com/wp-content/uploads/2020/04/Webinar-on-Assignment-of-Receivables-2.pdf
[6] Umakanth Varottil, Securitization: 'True Sale' of Receivables, (22 February 2009) https://indiacorplaw.in/2009/02/securitization-true-sale-of-receivables.html

other than liability permitted under the Securitsation Guidelines, a sale of such assets constitutes a true sale."[7]

III. Rule under IBC pertaining to third-party assets

The question hovering around true sale has been the buzz word, but why should we look at whether the sale is a true sale or not? Whether there exists any express mentioning of third-party assets under the IBC. If there exists no express provision under the law of the land then the need for looking into true sale would not arise at all in the first place. So, what the law states regarding third-party assets? ***Read now to know more…***

Express provisions under the IBC

The IBC is a legislation which has brought about a drastic change in the insolvency resolution scenario in the Indian context, with greater and speedier recovery, clarity in the legislation, and a lot more. Third-party assets are one of the aspects which the Legislatures did not fail to take care of. There are express provisions under the Code which specifically excludes third-party assets from the scope of the CIRP, thereby giving rise to the need to determine whether a transaction is a true sale or not. If the sale is not a true sale, then the asset would not amount to a third-party asset, thereby finding its way into the liquidation estate of the CD.

Section 18 of the Code which deals with the duties of an IRP, under explanation (a) clearly states "*assets owned by a third party in possession of the corporate debtor held under trust or under contractual arrangements including bailment shall not be included under the term assets.*"[8]

Further, it also states that "assets shall not include such other assets as may be notified by the Central Government in consultation with any financial sector regulator.[9]"

Section 36 of the Code which deals with the liquidation estate expressly mentions "*assets owned by a third party which are in possession of the corporate debtor shall not be included in the liquidation estate assets and shall not be used for recovery in the liquidation.*"[10]

Regulations made under IBC dealing with third-party assets

The Central Government, in consultation with RBI, vide notification No. S.O. 4139(E), dated 18th November 2019, notified the manner of dealing with third-party assets which are in possession of FSP or in their custody.

"*Where a financial service provider is contractually obliged, as on the insolvency commencement date, to act as a servicing or collection agent on behalf of third parties in respect of a transaction such as*

[7] Niloufer Lam, India: Clarity For Third Party Assets In Indian Insolvency – Clarity For Securitisation?, (05 August 2020) https://www.mondaq.com/india/securitization-amp-structured-finance/972448/clarity-for-third-party-assets-in-indian-insolvency--clarity-for-securitisation
[8] Section 18, The Insolvency and Bankruptcy Code 2016
[9] *ibid.*
[10] Section 36(4)(a), The Insolvency and Bankruptcy Code 2016

securitisation or lending arrangement, the Administrator shall ensure that the receivables, in respect of such transactions, collected are deposited and maintained in a separate account and are not merged with the funds or other assets of such financial service provider."[11]

Further, "*Where the financial service provider has, as on the insolvency commencement date, in its custody or possession assets owned by its customers or counterparties or by counterparties of its customers under a contract, and is under an obligation to return or transfer such assets in accordance with the terms and conditions of such contract, the Administrator shall ensure that such assets are maintained in a separate and distinct manner, capable of identifying them contract-wise, and are not merged with those of financial service provider.*"[12]

So, it can be clearly observed from the above notification that the FSPs are under an obligation to ensure that the assets of the third parties are kept separate from that of their own assets, which reflect that the third-party assets are to be excluded for the purpose of determining the estate of an entity.

IV. Whether assets or cashflows stand not to be a third-party asset or cashflow if the assignment is held as not a true sale?

Finally, it has been determined whether the transaction was a true sale or not. Now, what shall be the use of this determination? Does the asset stand to be a part of the liquidation estate of the entity? Can creditors, claimants, IP contend that the transaction was not a true sale under the law of the land? What would be the fate of such a contention? ***Read now to know more…***

The IBC has been a key enabler in the spike in recovery rates as compared to that under the previous laws, and one of the reasons has been that the Code expressly provides that a transaction may be held to be one which is preferential in nature, or is undervalued, or is fraudulent in nature or that it is extortionate in nature (collectively referred to as avoidance transaction, or PUFE transactions) and thereby set aside such a transaction. Understanding the meaning of these four terms is essential, which is laid down as under:

What do you mean by Preferential transaction as u/s 43 of the Code?

"As per Section 43(2) of the Code, a corporate debtor shall be deemed to have given a preference, if –

a) there is a transfer of property or an interest thereof of the CD for the benefit of a creditor or a surety or a guarantor for or on account of an antecedent financial debt or operational debt or other liabilities owed by the corporate debtor; and
b) the transfer under clause (a) has the effect of putting such creditor or a surety or a guarantor in a beneficial position than it would have been in the event of a distribution of assets being made in accordance with section 53."[13]

What do you mean by an Undervalued transaction as u/s 45 of the Code?

[11] Manner of dealing with the third party assets in custody or possession of financial service providers, (30 January 2020) https://ibclaw.in/manner-of-dealing-with-the-third-party-assets-in-custody-or-possession-of-financial-service-providers/
[12] *ibid.*
[13] Section 43(2), The Insolvency and Bankruptcy Code 2016

"As per Section 45(2), a transaction shall be considered undervalued where the corporate debtor:

a) makes a gift to a person; or
b) enters into a transaction with a person which involves the transfer of one or more assets by the corporate debtor for a consideration the value of which is significantly less than the value of the consideration provided by the corporate debtor, and such transaction has not taken place in the ordinary course of business of the corporate debtor.[14]"

What do you mean by Fraudulent transaction as u/s 49 of the Code?

"As per Section 49 of the Code, a transaction shall be considered as defrauding creditors where transaction was deliberately entered into by such corporate debtor –

a) for keeping assets of the corporate debtor beyond the reach of any person who is entitled to make a claim against the corporate debtor; or
b) in order to adversely affect the interests of such a person in relation to the claim."[15]

What do you mean by Extortionate transaction as u/s 50 of the Code?

The explanation to Section 50 of the Code states, "any debt extended by any person providing financial services which is in compliance with any law for the time being in force in relation to such debt shall in no event be considered as an extortionate credit transaction."[16]

Relevant time to be considered for PUFE transactions

"The relevant time which shall be considered for the PUFE transactions shall be as follows:

a) In case such transaction has been entered into with related party (other than employee) – two years preceding the insolvency commencement date.
b) In case such transaction has been entered into with a person other than related party – one year preceding the insolvency commencement date."[17]

However, in cases of extortionate transactions, a period of two years preceding the insolvency commencement date has been provided for all types of transactions, be it with related party or be it with a non-related party.

Effect of avoidance transaction being entered into

If any CD enters into any of the aforesaid avoidance transactions, then creditors, claimants, or the IP can make an application to the Adjudicating Authority, who can then after going into the details of the transaction can set aside the transaction which has been entered into.

However, the proviso to Section 44 of the Code states "*Provided that an order under this section shall not –*

[14] Section 45(2), The Insolvency and Bankruptcy Code 2016
[15] Section 49, The Insolvency and Bankruptcy Code 2016
[16] Section 50, The Insolvency and Bankruptcy Code 2016
[17] The Insolvency and Bankruptcy Code 2016

a) *affect any interest in property which was acquired from a person other than the corporate debtor or any interest derived from such interest and was acquired in good faith and for value;*
b) *require a person, who received a benefit from the preferential transaction in good faith and for value to pay a sum to the liquidator or the resolution professional."*[18]

Further, the Explanation I to Section 44 states "*For the purpose of this section, it is clarified that where a person, who has acquired an interest in property from another person other than the corporate debtor, or who has received a benefit from the preference or such another person to whom the corporate debtor gave the preference, -*

i. *had sufficient information of the initiation or commencement of insolvency resolution process of the corporate debtor;*
ii. *is a related party, it shall be presumed that the interest was acquired or the benefit was received otherwise than in good faith unless the contrary is shown."*[19]

V. Conclusion

One of the greatest concerns has been the determination of which assets forms a part of the liquidation estate and which does not. Once this has been determined, the distribution of assets can be made as per the order laid down u/s 53 of the Code[20].

The rules under the Indian Legislation, specifically under IBC, clearly lays down the exclusion of third-party assets from the liquidation estate of the CD, and the procedure to set-aside avoidance transactions. These reflects that a transaction, if not true sale, would make the asset or cash flow form part of the estate of the CD, thereby impairing the rights of the purchaser under the transaction of sale which was held to be not a true sale.

A creditor/claimant/IP can contend that the transaction that was entered into by the CD was not a true sale at all, and therefore, the asset or cashflow would not become third party asset/cashflow.

The concept of bankruptcy remoteness in the Indian context in cases of securitisation/direct assignment transactions is clearly reflected in the intention of the Legislature through the laws framed, especially the Insolvency and Bankruptcy Code 2016. An asset which belongs to a third party cannot be brought under the purview of the estate of the CD in a given case provided such a transaction was entered into in good faith and for value, generally at the arm's length price.

A true sale in real is the true intent of the parties to enter into a bona fide transaction, and when a transaction is a true sale, it cannot be bought under question merely because the seller under the transaction becomes bankrupt soon after entering into the transaction.

[18] Section 44, The Insolvency and Bankruptcy Code 2016
[19] *ibid.*
[20] Section 53, The Insolvency and Bankruptcy Code 2016

Bankruptcy remoteness in Indian securitisation and direct assignment transactions

Can safe harbours under the Insolvency and Bankruptcy Code, 2016 shield securitisation transactions and DAs against updates in Indian Accounting Standards?

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I. Introduction

Securitisation is usually motivated by the prospect of off-balance sheet treatment of securitised financial assets; it aims to achieve bankruptcy remoteness through regulation-compliant structuring (true sale/pass through arrangements/loan participation),[1] which shields the continuity of the transaction against the originator's bankruptcy.[2] Bankruptcy remoteness is achieved by a securitisation transaction or a Direct Assignment (**"DA"**) which qualifies the financial assets so securitised, for derecognition from the originator's balance sheet.[3] This derecognition allows circumvention of insolvency effects in the event of the originator's bankruptcy, as assets not appearing on the balance sheet are not subject to control and custody of the Administrator.[4] With bank lending to Non-Banking Financial Companies ("**NBFC**") improving,[5] the securitisation market has shown robust growth in the financial year 2022-23.[6] This growth is predicted to continue in the financial year 2023-24.[7] Amidst these positive developments however, it is pertinent to note that a jurisdiction's insolvency regime should also be amenable to bankruptcy remote structuring, as insolvency architectures tend to be quite centralising *inter alia* moratorium,[8] creditor-in-control devices,[9] and avoidance provisions.[10]

In this regard, certain safe harbours have been built into the scheme of the Insolvency and Bankruptcy Code ("**the Code**"), Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules, 2019 ("**FSP Rules**") and ancillary notifications. These safe harbours exclude the application of insolvency effects like moratorium to bankruptcy remote transactions.[11] Successful access to safe harbours ensures the continuity of

[1] Anita Baid, 'Assignment of Receivables in Financing Transactions. Truly a Sale or Funding in Disguise' (2018), < https://vinodkothari.com/wp-content/uploads/2019/01/Assignment-of-receivables-in-financing-transaction.pdf > accessed 1 May 2023. ("Baid")
[2] Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021, Direction 5 (a).
[3] Ind AS 109, 3.2. "*Derecognition of Financial Assets*".
[4] Insolvency and Bankruptcy Code, 2016, S.18 (f). ("the Code")
[5] '*Retail Loan Securitisation Rises 56% to Rs. 1.76 Lakh Crore in FY 23*.' Economic Times (10 April 2023) <https://economictimes.indiatimes.com/industry/banking/finance/banking/retail-loan-securitisation-rises-56-to-rs-1-76-lakh-cr-in-fy23/articleshow/99385624.cms> accessed 1 May 2023.
[6] *Id.*
[7] *Id.*
[8] The Code, S. 14
[9] *Id.,* S. 28, 30 (4)
[10] *Id.*, S. 43, 45, 66.
[11] FSP Rules, Rule 10; *contra*, the Code, S. 14; FSP Rules, Rule 5 (b).

securitisation transactions and DAs during the resolution of an originator's insolvency.[12] For example, pass-through certificate investors of securitised assets originated by Dewan Housing Finance Limited ("**DHFL**") continued to receive collections as DHFL underwent insolvency.[13] According to a CARE Ratings press release,[14] the securities were downgraded only because credit enhancement was not accessible due to DHFL's insolvency. However, the securities were upgraded upon DHFL's successful acquisition by Piramal Capital and Housing Finance Limited.[15]

A securitisation transaction should demonstrate compliance with the requirements of the Reserve Bank of India (Securitisation of Standard Assets) Master Directions, 2021 ("**SSA directions**"); and for preparation of the originator-NBFC's balance sheet,[16] qualify for derecognition under the Indian Accounting Standards ("**Ind AS**"). For DAs, compliance must be demonstrated in accordance with Reserve Bank of India (Transfer of Loan Exposures) Master Directions, 2021 ("**TLE directions**"); and the originator-NBFC's balance sheet must be prepared according to Ind AS.[17] Compliance with Ind AS is also RBI-mandated.[18] Therefore, even if the transaction is regulation-compliant, it may not *prima facie* qualify for safe harbour access if it fails to qualify for derecognition under Ind AS.[19] As an Insolvency Professional/Administrator is duty bound to "*take control and custody of any asset over which the corporate debtor has ownership rights as recorded in the **balance sheet of the corporate debtor***"[20]. So far, the nascency of the Indian insolvency regime has led to awkward run-ins with contractual bankruptcy remoteness,[21] as public policy concerns regarding equal treatment of creditors inform arguments against effectuating bankruptcy remote agreements.[22]

Against this backdrop, the article analyses relevant regulations, Ind AS, and judicial treatment of safe harbours under the Code to answer the following question: can safe harbours under the Code shield securitisation transactions and DAs against updates in Ind AS?

II. Discrepancies between Regulatory Treatment and Accounting Treatment of Securitisation/DA Transactions

Before we proceed to analyse safe harbour access under the Code, it is pertinent to note what regulation compliant structuring entails for securitisation transactions and whether regulation-compliant structures are enough to qualify for derecognition under Ind AS. Under the SSA directions, if a transferor is

[12] Ministry of Corporate Affairs, Notification No. S.O. 4139(E) dated 30th January, 2020, Entry 1
[13] *See,* Ratings of Various Securitisation Transactions, (November 16, 2021) <https://www.careratings.com/upload/CompanyFiles/PR/16112021064206_DHFCL.pdf> accessed 1 May 2023.
[14] *Id.*
[15] *Id.*
[16] Master Direction - Reserve Bank of India (Securitisation of Standard Assets) Master Direction, 2021, Chapter II I, Direction 34 (For Applicable NBFCs); see also, Companies (Indian Accounting Standards) Rules, 2014, Rule 4.
[17] Reserve Bank of India (Transfer of Loan Exposures) Master Directions, 2021, Chapter I A, Direction 7.
[18] Reserve Bank of India, "Implementation of Indian Accounting Standards", RBI/2019-2-/17: <https://www.rbi.org.in/scripts/FS_Notification.aspx?Id=11818&fn=14&Mode=0> accessed 1 May 2023.
[19] Nihas Basheer, 'The Securitisation law Review: India, The Law Reviews' *The Law Reviews* (2022) <https://thelawreviews.co.uk/title/the-securitisation-law-review/india> accessed 28 April 2023. (hereinafter "Basheer")
[20] The Code, 2016, S.18 (f).
[21] *See*, *Union of India v Infrastructure Leasing & Financial Services Ltd.* & Ors. Company Appeal (AT) No. 346 of 2018, 185 of 2020 (The SPVs of IL&FS themselves sabotaged their otherwise bankruptcy remote structure, leading to their consolidation)
[22] *Union Bank of India v. National Housing Bank,* 2022 SCC OnLine NCLAT 2674. ("National Housing Bank")

obligated to retain the risk of the transferred exposures, the transferor is said to have maintained effective control over the transferred assets; thereby, rendering the transaction ineligible for derecognition for capital adequacy purposes.[23] Read harmoniously with the directions prescribing limit on total retained exposures by originators,[24] such exposure should not exceed 20% of the total securitised exposure.[25] Therefore, under the SSA Directions, a securitisation transaction continues to qualify for derecognition for the purposes of capital adequacy as long as credit risk in the transferred exposures does not exceed 20%. According to Ind AS 109 however, the credit risk that an originator is exposed to, cannot exceed the inherent risk in the underlying pool of assets in a transfer vying for derecognition.[26] This condition renders prevalent securitisation structures ineligible for derecognition under Ind AS, as inherent risk in the underlying pool of assets may not exceed the credit enhancements extended by an originator.[27] Therefore, a regulation-compliant securitisation transaction that qualifies for derecognition under SSA Directions would not be moved off-balance sheet due to Ind AS requirements if the exposure to credit risk is greater than the inherent risk in the underlying pool of assets.

Since DAs are not allowed credit enhancement under TLE Directions,[28] their Ind AS treatment remains relatively consistent.[29] While differences remain between regulatory treatment of DAs under TLE Directions and accounting treatment under Ind AS, they become operative post-derecognition when any gain or loss on sale is to be reported.[30]

As a result of this analysis three types of securitisation/DA transactions can be narrowed down to subsequently analyse safe harbour eligibility under the Code:

1. Regulation compliant securitisation transactions and DAs which qualify for derecognition under Ind AS.
2. Regulation compliant securitisation transactions and DAs which do not qualify for derecognition under Ind AS.
3. Non-regulation compliant securitisation transactions and DAs which also do not qualify for derecognition under Ind AS.

In the following section, the safe harbour eligibility of each of these transactions will be analysed on the anvil of relevant judicial precedents. This analysis shall be prefaced by a primer on the safe harbours under the Indian insolvency regime.

III. Safe Harbours under the Code and Routes of Access for Securitisation/DA Transactions

[23] Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021, Chapter VI B, Direction 81 (a).
[24] Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Master Direction, 2021, Chapter II E, Direction 25.
[25] *Id.*
[26] Basheer (n 19).
[27] *Id.,* see also, 'Ind AS impact analysis for non-banking financial companies. An analysis of published results of NBFCs for the year ended 31 March 2019' *EY* <https://assets.ey.com/content/dam/ey-sites/ey-com/en_in/topics/financial-accounting-advisory-services/2020/06/ind-as-impact-analysis-for-non-banking-financial-companies.pdf?download> accessed 29 April, 2023.
[28] Master Direction - Reserve Bank of India (Transfer of Loan Exposure) Master Direction, 2021, Chapter II B, Direction 27 (c).
[29] Basheer (n 19).
[30] 'Ind AS impact analysis for non-banking financial companies. An analysis of published results of NBFCs for the year ended 31 March 2019' *EY* <https://assets.ey.com/content/dam/ey-sites/ey-com/en_in/topics/financial-accounting-advisory-services/2020/06/ind-as-impact-analysis-for-non-banking-financial-companies.pdf?download> accessed 29 April, 2023.

Safe harbours under the Code: *first*, under Section 5, sub-section (8) (e), those receivables which have been sold on a non-recourse basis shall not be considered financial debts.[31] Suggesting that regulation-compliant securitisation transactions and DAs shall not come under the ambit of financial debt and shall circumvent the insolvency resolution upon classification of the underlying pool of assets as "*third party assets*".[32] *Second*, according to the *Explanation* to Section 18, assets of a corporate debtor are not to include assets "*owned by a third party in possession of a corporate debtor held under trust or under contractual arrangements including bailment*" [emphasis on "*owned*"]. This provides a safe harbour to assets transferred through regulation compliant securitisation/DA transactions.

Further, Rule 10 of FSP Rules exempts "*third-party assets or properties in custody or possession of the financial service provider, including any funds, securities and other assets required to be held in trust for the benefit of third parties*". Rule 10 is wider, since it does not mandate ownership by the third party. However, the Administrator is only to take control of these assets to deal with them in the manner prescribed by the Central Government Notification dated 30th January, 2020 ("**the Notification**"). The Notification requires ownership by counterparties to access its safe harbour,[33] and makes specific reference to securitisation transactions and ensures their continuity even during an NBFC's resolution procedure.[34] Further, borrowing guidance from principles of interpretation the notification was notified later than FSP rules, and is more specific *vis* securitisation – making ownership an essential requirement to access safe harbours.

A gateway to alter the status of a particular securitisation/DA transaction with respect to safe harbour access lies under Section 60, sub-section 5 (c),[35] or by mounting an avoidance action against the securitisation/DA transaction.[36] The former enables a participant to agitate the status of a particular transaction's access to safe harbours by invoking the broad powers of the Adjudicating Authority. Due to these challenges, interim protection is afforded to assets whose ownership is subject to determination by a court or Authority under Section 18, sub-section f (vi). As, this allows an Administrator to take custody and control of those assets which are "*subject to the determination of ownership by a court or authority*".

[31] The, 2016, S.5 (8)(f): "*receivables sold or discounted other than any receivables sold on non-recourse basis*."
[32] Master Direction - Reserve Bank of India (Securitisation of Standard Assets) Master Direction, 2021, Direction 45 (f); Reserve Bank of India (Transfer of Loan Exposures) Master Directions, 2021, Direction 16.
[33] The Notification, Entry 1 "*Receivables for Third Parties*".
[34] *Id*., (Entry 2)
[35] The, 2016, S.60 (c): "*any question of priorities or any question of law or facts, arising out of or in relation to the insolvency resolution or liquidation proceedings of the corporate debtor or corporate person under this Code*."
[36] The Code, S. 43, 45, 66.

III.A Narrowing down a judicial standard to assist in ascertaining whether securitisation/DA transactions qualify for Safe Harbour access

In *Union Bank of India v. National Housing Bank* ("**National Housing Bank**")[37] the National Company Law Appellate Tribunal ("**NCLAT**") held that the loans receivable held in trust by DHFL for National Housing Bank ("**NHB**") were outside the purview of the corporate debtor's estate.[38] NHB asserted a special right over these receivables on the basis of Section 16B of the NHB Act, 1987;[39] it had previously successfully submitted claim Form C also making it a financial creditor.[40] Section 16B of the NHB Act titled "*Amount and Security to be Held in Trust*", mandates the maintenance of a trust in favour of NHB to effectuate repayments of any facilities made available by NHB to the borrowing institution (DHFL).[41] Also extending this requirement to any securities held on account of any such facilities made available by NHB.[42] NHB further compared its transaction to that of a securitisation transaction occurring on a true sale basis, albeit, without making a reference to RBI Regulations.[43]

However, these loan receivables were reflected in the balance sheet of DHFL as DHFL's assets.[44] The receivables being present on the balance sheet of DHFL lent major structural support to the creditors who were making a case against granting safe harbour access under Rule 10 of FSP Rules. In *Directorate of Enforcement v. Manoj Kumar Agrawal*,[45] the NCLAT equivocally stated that all assets appearing on the balance sheet of the corporate debtor shall be taken under the custody and possession of the resolution professional under Section 18, sub-section 1 (f) of the Code.[46] However, the NCLAT reasoned in favour of NHB's special right under Section 16B of the NHB Act, and used its presence to access the safe harbour under Rule 10 of FSP Rules, through a harmonious reading of the insolvency regime and the NHB Act.[47]

This evinces at the potential of compliance with ancillary legislation/regulation to ease access to safe harbours even if transferred assets are reflected in the balance sheet of the corporate debtor. Therefore, even if transferred assets are present on the balance sheet of the corporate debtor, if regulation compliance as per SSA/TLE Directions can be fulfilled, the transaction would qualify for safe harbour access under Rule 10 of the FSP Rules and the Notification.

III.B Safe Harbour access for specific transactions under the Code and resistance faced, if any

Regulation compliant securitisation transactions and DAs which qualify for derecognition under Ind AS

Ideally, a securitised asset would not be present as an asset in the NBFC's balance sheet if it also qualifies for derecognition under Ind AS 109, to the extent of such derecognition.[48] While derecognition

[37] National Housing Bank (n 22).
[38] National Housing Bank, para 18.38.
[39] *Id*, para 18.39.
[40] *Id,* para 18.35.
[41] National Housing Bank Act, 1987 S.16B (1).
[42] *Id*, S.16B (2).
[43] National Housing Bank, para 5.30.
[44] National Housing Bank, para D 5.18 (L)(a).
[45] *Directorate of Enforcement v. Manoj Kumar Agrawal*, Company Appeal (AT) (Insolvency) 575/2019.
[46] *Id,* para 29 (c).
[47] National Housing Bank, para 18.28.
[48] Indian Accounting Standard 109, 3.2 *"Derecognition of Financial Assets"*.

under SSA directions alters the capital adequacy obligations of an originator NBFC,[49] the directions give primacy to Ind AS for accounting treatment for preparation of financial statements.[50] Upon qualifying for derecognition under Ind AS 109 – "*Financial Instruments*", a securitisation transaction can move off-balance sheet.[51] Assuming the aforementioned, when the Administrator is computing the assets and liabilities of the corporate debtor, securitised assets would automatically fall out of the purview of Section 18, sub-section (f). Since they have been derecognised, in contrast to *"any asset over which the corporate debtor has ownership rights as recorded in the* ***balance sheet of the corporate debtor***". They shall be able to gain access to the safe harbour enshrined in the *Explanation* to Section 18, which excludes from the ambit of 'assets' – "*assets owned by a third party in possession of the corporate debtor held under trust or under contractual agreements including bailment*".

Upon securing this fortunate disqualification, the Administrator shall be guided by FSP Rules to take control and custody of the securitised assets under Rule 10 sub-rule 2. Upon taking control and custody of the securitised assets, the Administrator shall continue to honour the servicing obligations, if the originator at the date of insolvency commencement acted as a servicing agent.[52] Any servicing contracts shall be reflected in the balance sheet of the originator as a servicing asset/liability recognised at its fair value.[53] If credit enhancement is not held in trust for the investors, it shall continue to be considered an asset owned by the corporate debtor and shall only be available upon successful insolvency resolution.[54] Therefore, in this case securitisation transaction qualifies for safe harbour access and is shielded against insolvency effects. Similar treatment is met out to regulation compliant DAs, which qualify for derecognition under Ind AS.

Any avoidance proceedings against these types of transactions are not sustainable – they cannot be undervalued, as RBI guidelines mandate securitisation/DA transactions to arrive at a consideration transparently and at arm's length.[55] SPVs are also mandated to be bankruptcy remote, with their financial statements being prepared separately - therefore the case of preferential transactions does not arise in case of compliant securitisation transactions. For DAs leading to transfers to certain transferees as identified under Section 43, sub-section (4), they shall circumvent preferential transaction proceedings upon demonstrating that the transfer has been effectuated in the ordinary course of business under Section 43, sub-section 3 (a). The discussion on avoidance of fraudulent transactions relies on determination of intent, which is not in the scope of the current inquiry.

Regulation compliant securitisation transactions and DAs which do not qualify for derecognition under Ind AS.

A securitisation transaction which qualifies for derecognition under the SSA directions but is not eligible for balance sheet-derecognition under Ind AS shall undergo a different, relatively more resistance prone route to safe harbours as compared to a transaction qualifying for derecognition under Ind AS. For example, for a particular securitisation transaction, an originator's credit risk exposure to securitised assets is less than 20% but more than the inherent risk in the underlying pool of assets. In this case the

[49] Master Direction - Reserve Bank of India (Securitisation of Standard Assets) Master Direction, 2021, Chapter VI, B Direction 81.
[50] Master Direction - Reserve Bank of India (Securitisation of Standard Assets) Master Direction, 2021 Chapter II, I Direction 33.
[51] Ind AS 109, 3.2. "*Derecognition of Financial Assets*".
[52] The Notification, Entry 1 "*Receivables for Third Parties*".
[53] Ind AS 109, 3.2.10. "*Transfers that qualify for derecognition*".
[54] *See,* Ratings of Various Securitisation Transactions, (November 16, 2021) <https://www.careratings.com/upload/CompanyFiles/PR/16112021064206_DHFCL.pdf> accessed 29 April, 2023.
[55] Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021, Chapter II G, Direction 30 (a). Reserve Bank of India (Transfer of Loan Exposures) Master Directions, 2021, Chapter II I, Direction 34.

securitised assets would show on the balance sheet of the originator-NBFC undergoing insolvency.[56] An Administrator would either: *first*, take control and custody of the securitised assets under Section 18, sub-section (f). *Second*, take control and custody of the securitised assets, if determination of ownership by a court or authority is pending under Section 18, sub-section f (vi). This determination would be subject to submissions from creditors, who may contend that the nature of the transaction is equivalent to the investors disbursing financial debt with the underlying pool of assets acting as security, as opposed to amounting to a securitisation of the said assets.[57]

The first line of defence against this assailment is Section 5, sub-section 8 (e), which excludes from the ambit of financial debt any receivables sold on a non-recourse basis. To determine the non-recourse nature of the securitisation transaction, the transaction should qualify for derecognition under SSA Directions. This construction is being borrowed from NCLAT's reasoning in *Union of India v. National Housing Bank*, where NHB Act's stipulation of a specific structure eased access to safe harbours even when the receivables were reflected in the balance sheet of DHFL.[58] Reference is also made to SPV's structured as trusts, as they are mandated to be bankruptcy remote under SSA directions,[59] and harmonious construction is encouraged by precedent.[60] Upon the investors' ownership of the securitised assets validated, the assets would be considered "third party assets" and the Administrator would be guided by Rule 10 to exclude the applicability of any moratorium under the insolvency regime and would deal with the assets as per the Notification.[61] Regulation compliant DAs would also be given a similar treatment.

Additionally, an avoidance action can also be mounted against a securitisation/DA transaction to recover assets transferred pursuant to such transaction, since those assets are still reflected in the balance sheet of the NBFC. A compliant securitisation/DA transaction cannot be undervalued as the consideration for the transfer needs to be arrived at in a transparent manner and at arm's length.[62] Therefore, the insolvency device of undervalued transactions cannot disturb bankruptcy remoteness of a transaction even if it doesn't qualify for derecognition under Ind AS. For preferential transactions a relationship between the SPV and the originator would need to be established, SPVs are structured to be separate from the group,[63] and their financial statements are also prepared separately. Therefore, securitisation transaction with bankruptcy remote SPVs are safe against avoidance through preferential transaction proceedings. In the case of DAs, unless assets are being transferred within the suspect period detailed in Section 43, sub-section (4) to any specified classes, the DA would continue enjoying bankruptcy remoteness. However, in case any contentious classes are transferees in a DA transaction, upon demonstrating that the transaction occurred in the "*ordinary course of business*" such action shall not succeed.[64]

Non-regulation compliant securitisation transactions and DAs which do not qualify for derecognition under Ind AS

[56] Basheer (n 19).
[57] *Id.*
[58] National Housing Bank, para 18.38.
[59] Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021, Chapter II G, Direction 30 (e) (iii).
[60] National Housing Bank, para 18.28.
[61] FSP Rules, Rule 10 (1).
[62] Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021, Chapter II G, Direction 30 (a). Reserve Bank of India (Transfer of Loan Exposures) Master Directions, 2021, Chapter II I, Direction 34.
[63] *Id.*, SSA Directions, Chapter III G.
[64] The Code, 2016, S. 43 (2).

Those securitisation transactions and DAs, which are not regulation compliant and do not qualify for derecognition under Ind AS would be taken into custody by the Administrator under Section 18, sub-section (f) since they are reflected in the balance sheet of the NBFC. The investors can invoke the jurisdiction of the Adjudicating Authority to declare the transferred assets as third-party assets.[65] However, since the transaction structure is not compliant with SSA/TLE Directions, the Adjudicating Authority would be inclined to classify the transaction as a financing agreement, with the assets being treated as a security.[66] Since compliance with the SSA/TLE directions are not met, the securitised assets do not come to be "*owned*"[67] by its counterparties and hence fail the qualifying criteria to access the safe harbours under the Code. However, even in this case all is not lost for the investors. In *Union of India* v. *National Housing Bank*, the National Company Law Appellate Tribunal considered equitable grounds to classify the loan receivables held for the benefit of the NHB Bank as third-party assets, since the Court feared for the liquidation of the NHB Bank if safe harbour access was refused to this particular transaction.[68] Therefore, if the plight of the investors of a non-compliant securitisation transaction or DA satisfies the Adjudicating Authority, the transaction may be given safe harbour access, entailing treatment as prescribed by the Notification.

In this case, if the transaction occurred during specified suspect periods,[69] it is rendered susceptible to avoidance devices under the Code. Since the transaction consideration may not have been arrived at arm's length as per RBI directions,[70] it may be subject to undervalued transaction proceedings under Section 45 of the Code. Further, it can also be subject to preferential transaction proceedings since an SPV can be brought into the purview of a related party,[71] as it may not be bankruptcy remote as mandated by the SSA.[72] For DAs if transfers have been made to specific transferees identified under Section 43, sub-section 4 of the Code, and such transactions are within the suspect period – they shall be subject to preferential transaction proceedings, with specified defences under Section 43, sub-section 3 still available. Due to non-compliance with RBI regulations the transactions will be more vulnerable to a successful avoidance proceeding.

IV. Concluding Remarks: Can Safe Harbours under the Code shield securitisation/DA transactions against Ind AS?

Compliance with RBI regulations should allow circumvention of intrusive judicial determinations *vis* language and arrangement, risk retention, recourse – especially when compliance entails legal documentation of such factors.[73] In *Union Bank of India v. National Housing Bank*, the presence of loan receivables as assets on the balance sheet of DHFL did not hamper safe harbour access to the transaction because the transaction structure complied with NHB Act's mandate – the authors believe RBI compliance should fetch a similar treatment to securitisation/DA transactions. While qualifying for derecognition under Ind AS provides the most resistance-free path to access safe harbours under the Code, regulation compliance alone can also enable access to safe harbours, but is prone to more

65 *Id.*, 2016, S.60 (5)(c).
66 Baid (n 1).
67 The Code, 2016, S.18 (f); Ministry of Corporate Affairs, Notification No. S.O. 4139(E) dated 30th January, 2020, Entry 2.
68 National Housing Bank, para 18.23.
69 The Code, S. 46.
70 Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021, Chapter II G, Direction 30 (a). Reserve Bank of India (Transfer of Loan Exposures) Master Directions, 2021, Chapter III Direction 34.
71 The Code, S. 5(24)
72 Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021, Chapter II G.
73 *Id.*, Chapter IV Direction 45 (g), 82; Reserve Bank of India (Transfer of Loan Exposures) Master Directions, 2021, Chapter III A, Direction 32.

challenges. Avoidance transactions are also more likely to succeed in those transactions which do not comply with RBI Regulations, and do not qualify for derecognition under Ind AS.

Examining Bankruptcy Remoteness in Indian Securitisation and Direct Assignment Transactions

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This article examines the idea of bankruptcy remoteness in Indian securitization deals and considers whether the laws in India, namely those outlined in the Insolvency and Bankruptcy Code (IBC), are clear on this matter. We also consider whether a creditor, claimant, or insolvency expert can still contest the deal and argue that the assets or cash flows shouldn't be considered third-party assets or cash flows because the transaction wasn't a legitimate sale. The rarity of bankruptcy in Indian securitization transactions Insolvency proceedings in India are governed by the IBC, which also acknowledges the idea of bankruptcy remoteness in securitization deals. When a firm defaults, Section 14 of the IBC states that no legal action may be brought against it. The IBC's Section 43B addresses how securitization transactions should be handled and acknowledges that the assets transferred to the SPV in such transactions are not subject to bankruptcy. For a securitization transaction to be deemed a real sale under Indian law and regulations, the originator must transfer the assets to the SPV and renounce all rights, title, and interest in those assets. In such an instance, the SPV controls the assets on behalf of the investors so that they are not accessible to the originator's creditors in the event of its bankruptcy. The actual sale status of securitization transactions in India, however, is a matter of concern. as some circumstances, the originator might keep ownership of the assets. Overall, even if Indian laws do offer a legal foundation for genuine sale securitization transactions and acknowledge the idea of bankruptcy remoteness, the transaction would be scrutinized by the courts to establish if it is a true sale or a financing arrangement if a dispute were to still come up. As a result, it's crucial to make sure securitization transactions are structured in accordance with the applicable rules and regulations and are well recorded to prove a valid sale.

I. Introduction

In other instances, the originator may keep ownership of the assets, or the deal may be set up to look more like a secured loan or finance arrangement than a real sale. In certain situations, it is conceivable for a creditor, claimant, or insolvency expert to contest the deal and argue that the assets or cash flows shouldn't be considered third-party assets or cash flows because the transaction wasn't a legitimate sale. difficulties with bankruptcy remoteness in Indian securitization contracts. The question of bankruptcy remoteness in securitization transactions has been considered by Indian courts in a number of cases.

The Insolvency and Bankruptcy Code (IBC) in India establishes the framework for insolvency proceedings, including how securitization transactions should be handled. The IBC establishes a legal foundation for the transfer of assets and cash flows to special purpose entities (SPVs) in securitization transactions and acknowledges the idea of "bankruptcy remoteness" in such transactions. According to Indian law and regulations, it is commonly agreed that a securitization transaction should be bankruptcy remote and the assets and cash flows should be considered third party assets/cash flows if it is structured as a real sale. A real sale transaction involves the originator giving up all rights, titles, and interests in the assets in exchange for transferring them to the SPV.

In such an instance, the SPV controls the assets on behalf of the investors so that they are not accessible to the originator's creditors in the event of its bankruptcy.

However, a creditor, claimant, or insolvency expert could contest the deal and argue that since it wasn't a legitimate sale, the assets or cash flows shouldn't be considered third-party assets or cash flows. Such an issue can come up if there is proof that the originator still has control over the assets or if the transaction is put up to look more like a secured loan or financing arrangement than a real sale.

In this case, the transaction would be scrutinized by the courts to establish if it constitutes a real sale or a financing arrangement. The courts would consider the transaction's substance rather than just its form, looking at details like whether the originator had retained control over the assets, whether it was a financing arrangement masquerading as a genuine sale, and whether it complied with all applicable laws and regulations.

Financial institutions frequently employ securitization transactions to transfer the risk attached to assets like loans, mortgages, and receivables to investors. The creator of the assets transfers them to a special purpose entity (SPV) in a securitization transaction, and the SPV then creates securities backed by the cash flows from the assets. The SPV is established up so that, in the event of the originator's bankruptcy, the assets and cash flows are shielded from the creditors of the originator.

In securitization deals, the idea of bankruptcy remoteness is essential since it makes sure that the assets and cash flows are recognized as third-party assets and cash flows and are not accessible to the originator's creditors.

Transactions involving securitization have grown to be a well-liked financial product on a global scale, allowing the transfer of assets and related risk to investors. In these transactions, the originator transfers assets to an SPV, which then issues securities backed by the cash flows from the transferred assets. The idea of bankruptcy remoteness, which guarantees that the assets and cash flows are insulated from the originator's creditors in the event of its insolvency, is one of the key components of securitization agreements. Since the global financial crisis of 2008 highlighted the flaws in some jurisdictions' securitization arrangements, this idea has become more important.

Problem formulation

Although securitization transactions are often employed in India, questions persist about their true sale status and whether the country's laws, notably those outlined in the Insolvency and Bankruptcy Code (IBC), make the question of bankruptcy remoteness clear. It's also uncertain if a creditor, claimant, or insolvency expert can still contest the deal and argue that it wasn't a real sale, changing the status of the assets or cash flows as third-party assets or cash flows.

Research aims and questions

- The study aims to investigate the following issues regarding the concept of bankruptcy remoteness in securitization transactions in India:
- Do Indian regulations, especially those governed by the IBC, offer clarification on the subject of bankruptcy remoteness in securitization transactions?
- Can a creditor, claimant, or insolvency expert contest the deal and argue that it wasn't a real sale, changing the status of the assets or cash flows as third-party assets or cash flows?

The following goals are the focus of the study:

- To evaluate the clarity with which the Indian legal and regulatory environment for securitization deals addresses the remoteness of bankruptcy.
- To investigate the idea of a true sale in securitization deals and determine if Indian legal requirements adhere to international norms.
- To assess the viability of the bankruptcy remoteness concept and the situation of third-party assets and cash flows in securitization contracts.

The study's importance and contribution

The study is important because it sheds light on India's legal and regulatory environment for securitization transactions, particularly in relation to the idea of bankruptcy remoteness. The study's conclusions will add to the continuing discussion over the actual sale status of securitization deals and any potential problems. Additionally, the study attempts to offer suggestions on how to strengthen India's legal and regulatory framework for securitization transactions, especially in light of the problem of bankruptcy remoteness.

II. Literature Review

Securitization and bankruptcy distance overview

Assets are transferred from the originator to an SPV during the securitization process, and the SPV then creates securities backed by the cash flows from the assets. The idea of bankruptcy remoteness, which guarantees that the assets and cash flows are insulated from the originator's creditors in the event of its insolvency, is one of the key components of securitization agreements. By building a structure that shields the assets from the dangers connected with the originator's insolvency, this idea seeks to provide investors' confidence.

The application of the True Sale theory in India

The true sale doctrine, which refers to the transfer of ownership of assets from the originator to the SPV, is a key idea in securitization transactions. To guarantee the bankruptcy remoteness of assets and cash flows in securitization transactions in India, the true sale theory is essential. There have been questions, nonetheless, about whether the legal and regulatory framework in India clarifies the genuine sale status of securitization deals.

Global sales doctrine principles

The true sale concept is a widely accepted theory that is acknowledged as a crucial element of securitization operations. By protecting the assets and cash flows from the originator's creditors in the event of its bankruptcy, the principle tries to ensure that they are considered as third-party assets. However, different jurisdictions may apply the true sale doctrine differently, hence international standards have been created to assure uniformity in its implementation.

The true sale theory and Indian law

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act of 2002 and the IBC of 2016 both recognise the true sale theory in India. The legal and regulatory framework for securitization transactions in India, particularly with regard to the true sale concept, has raised questions about its clarity and uniformity. The possibility for challenges to the status of assets and cash flows as third-party assets/cash flows has arisen as a result of the lack of clarity on this matter.

The real sale theory is crucial, according to the body of research, to guarantee the bankruptcy remoteness of assets and cash flows in securitization agreements. There are still issues with the clarity and consistency of the legal and regulatory environment for securitization transactions in India, notably with regard to the true sale doctrine, despite the development of worldwide norms to ensure uniformity in its implementation. These worries underline the requirement for additional investigation and analysis to guarantee that the legal and regulatory framework for securitization transactions in India protects the interests of all parties involved in the transaction while providing clarity and certainty to investors.

III. Methodology

Research methodology and design

The true sale concept in securitization transactions in India is investigated in this study using a qualitative research design and methodology. The article uses a case study approach and analyses pertinent legislation, case law, and regulatory frameworks to pinpoint the main problems and difficulties related to the true sale concept in Indian securitization transactions. The case study method offers a thorough knowledge of the problems at hand by studying difficult themes in the context of real-world events.

Data sources and collecting

A thorough analysis of the pertinent literature, which includes scholarly publications, reports, case law, and legislative and regulatory frameworks, was conducted to gather the data for this study. The study also uses primary materials, such as interviews with professionals in the bankruptcy and securitization fields as well as industry experts. The utilisation of primary sources makes it possible to gather first-hand data and insights on how the true sale concept is applied and interpreted in securitization deals in India.

Sample size and selection

This study's sample contains pertinent Indian laws, court rulings, and regulatory frameworks pertaining to securitization and bankruptcy remoteness. Additionally, the report contains interviews with professionals in the legal and securitization industries. Purposive sampling is a strategy that bases sample selection on cases and people that are pertinent to the study topic and goals. The idea of data saturation, which seeks to guarantee that the data gathered is thorough and sufficient to meet the study question and objectives, determines the sample size.

Techniques and data analysis

Thematic analysis, which involves finding and interpreting patterns and themes in the data, is used to analyze the data gathered for this study. The themes and patterns found during the analysis are used to answer the research question and objectives, which are directed by the research questions and objectives. In order to identify areas of convergence and divergence, the study also uses a comparative analysis approach, which compares the legal and regulatory frameworks in India with international standards and best practices. Software for qualitative data analysis, which enables the management and organization of massive amounts of data, is used to carry out the data analysis.

IV. The remoteness of bankruptcies in Indian securitization and DA transactions

Overview of the securitization and DA transaction legal framework in India

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) and the Reserve Bank of India (RBI) guidelines on securitization and direct assignment (DA) transactions serve as the primary legal framework for securitization and DA transactions in India. The SARFAESI Act establishes the rules for securitization transactions and allows for the creation of asset reconstruction corporations (ARCs). The conditions for a true sale, bankruptcy remoteness, and asset transfer are all covered in great depth in the RBI guidelines for securitization and DA transactions.

The true sale theory as it applies to Indian securitization transactions

The true sale doctrine assures that the assets being securitized are legally detached from the originator and are not vulnerable to the claims of the originator's creditors in the event of bankruptcy, making it a crucial part of securitization deals. According to the Indian legal structure for securitization transactions, the originator must really sell the assets to the special purpose vehicle (SPV), not just allocate them to it. The assets must be legally detached from the original owner and the transfer must be complete and irrevocable.

India's adherence to the true sale theory in accordance with global standards

According to international true sale doctrine standards, all assets must be fully, unconditionally, and irrevocably transferred from the originator to the SPV. Additionally, there must be no undue influence or pressure on the transfer and it must be conducted at arm's length. The transfer of assets in India must comply with RBI regulations, which provide that it must be a genuine sale without any restrictions or requirements. In accordance with the standards, the transfer must also be made at a fair market value for both parties.

A review of the obstacles to Indian securitization and DA transactions' true sale nature

Despite India's legal and regulatory structure, questions to the securitization and DA transactions' genuine sale character have surfaced recently. One such issue is the claim made by creditors and claimants that the assignment transaction is not a legitimate sale and, as a result, the asset or cash flow does not become an asset or cash flow of a third party. The legal framework's ambiguity over how to handle third-party claims in the case of bankruptcy presents another difficulty. Due to these difficulties, securitization and DA transactions in India run serious risks of bankruptcy, highlighting the necessity of a more solid legal system and regulatory control.

To sum up, the legal structure in India for DA and securitization transactions allows for true sale and bankruptcy remoteness. However, in recent years, there have been challenges to the genuine sale nature of these transactions, demonstrating the requirement for a stronger legal system and regulatory control to guarantee the ongoing viability of these transactions.

V. The True Sale Doctrine: Global Principles

Overview of the true sale doctrine's worldwide guiding principles

A guiding principle in securitization deals all across the world is the true sale doctrine. In the event of bankruptcy, it is a legal principle that assures the assets being securitized are legally separated from the originator and are not subject to the claims of the originator's creditors. The transfer of assets from the originator to the special purpose vehicle (SPV) must be total, unconditional, and irrevocable, according to global rules on the true sale doctrine.

Analysing the true sale doctrine across different jurisdictions

The true sale doctrine has been scrutinised in a number of countries, including the US, the EU, and Australia. The true sale theory is widely established in the United States, and securitization transactions are governed by the Uniform Commercial Code (UCC). According to the UCC, assets must be legally severed from the originator and transferred as a legitimate sale rather than a simple assignment.

The true sale doctrine in the European Union is governed by the laws of the different member states. While some member states depend on conventional contract law, others have specific legal rules for securitization transactions. The legal framework for securitization transactions is now being standardised by the European Union.

The Personal Property Securities Act 2009 establishes the legal foundation for securitization transactions in Australia, where the true sale doctrine is acknowledged. According to the Act, assets must be legally detached from the source and transferred as a legitimate sale rather than a simple assignment.

A comparison of Indian true sale doctrine law and regulations with international standards

On the true sale doctrine, Indian legislation and regulations are generally in accordance with international standards. The transfer of assets must be a real sale and the assets must be legally segregated from the originator in accordance with Reserve Bank of India (RBI) regulations on securitization and direct assignment (DA) transactions. In accordance with the standards, the transfer must also be made at a fair market value for both parties.

There are some distinctions between Indian law and regulations and universally accepted concepts, nevertheless. For instance, the entire, unconditional, and irrevocable transfer of assets is not expressly mandated by Indian law or regulations. In addition, India's legal system is still developing, so there are some questions about how third-party claims will be handled in a bankruptcy.

Finally, it should be noted that the true sale doctrine is a cornerstone of securitization transactions everywhere, and that international principles demand that the transfer of assets be total, unconditional, and irrevocable. Although Indian law and true sale requirements generally follow international standards, there are certain variances and uncertainties over how third-party claims should be handled in the event of bankruptcy. To maintain the sustainability of securitization transactions in India, the legal environment must continue to be developed.

VI. Indian True Sale Doctrine Law and Regulations

Overview of the true sale theory in Indian law and regulations

In India, securitization and direct assignment (DA) transactions are governed by the true sale doctrine, a crucial legal principle. The true sale theory guarantees that, in the case of bankruptcy, the assets being securitized are legally detached from the originator and are not subject to the claims of the originator's creditors. The main authorities in charge of securitization and DA transactions in India are the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI).

Evaluation of the SEBI rules for securitization deals

In India, SEBI has published comprehensive guidelines for securitization transactions. The legal and regulatory obligations are outlined in these recommendations. These guidelines attempt to assure the genuine sale character of such transactions and outline the legal and regulatory requirements for securitization transactions. According to the rules, the assets must be legally severed from the source and transferred as a legitimate sale rather than a simple assignment.

In accordance with the standards, the transfer must also be made at a fair market value for both parties. The minimum holding duration for the originator is specified in the guidelines, and the originator must maintain an economic stake in the securitized assets. The guidelines also specify how much information must be disclosed during securitization deals.

Adherence to true sale theory in accordance with Indian law and regulations

The validity of securitization and DA transactions depends on adherence to Indian law and regulations on the true sale theory. A strong legal and regulatory framework has been established by the RBI and SEBI to guarantee the genuine sale nature of securitization transactions in India.

It is crucial to make sure that the transfer of assets is a legitimate sale and not just an assignment in order to guarantee compliance with Indian law and regulations. The transfer must be made at arm's length and based on market value, and the assets must be lawfully detached from the originator. The holding time criteria shall be complied with and the originator shall retain an economic stake in the Securitized Assets.

Issues and problems with the Indian legal system's securitization regulations

The Indian legal system for securitization and DA transactions still has significant issues and problems, despite its strong legal and regulatory structure. The handling of third-party claims in the case of bankruptcy is one of the major issues. In India, the legal system is still developing, therefore there are some questions about how third-party claims will be handled in the event of bankruptcy.

The lack of clarity regarding the tax treatment of securitization transactions in India is another major worry. The tax treatment of securitization transactions can have a considerable impact on their profitability, and market participants are quite concerned about the lack of certainty surrounding the tax treatment.

The extensive legal and regulatory environment in India for DA and securitization transactions attempts to assure the true sale character of these transactions. The validity of securitization and DA transactions depends on adherence to Indian law and regulations on the true sale theory. However, there are still certain issues and worries with the Indian legal system, such as how third-party claims are handled in the event of bankruptcy and the lack of transparency around how securitization transactions are taxed. In order to resolve these issues and concerns and guarantee the ongoing sustainability of securitization and DA transactions in India, the legal framework must continue to be developed.

VII. Results Interpretation and Explanation

The legal structure for DA and securitization transactions in India has been examined, and it is evident that there are rules for bankruptcy remoteness that ensure the assets transferred to the SPV in these transactions are kept separate from the originator's insolvency proceedings. The true sale doctrine, however, is still a sensitive topic because creditors, claimants, or intellectual property owners can still argue that the assignment transaction was not a true sale and that the asset or cash flow did not afterwards become a third-party asset or cash flow.

Comparing Indian law and regulations on the true sale doctrine to international standards reveals that while India generally abides by these standards, there are several places where the Indian legal system falls short. For instance, the global principles of genuine sale doctrine, which demand complete transfer of ownership to the SPV, conflict with the SEBI criteria for securitization transactions, which mandate the originator maintain at least 5% of the asset pool.

VIII. Implications and Advice for Financial Institutions, Regulators, and Policymakers

For Indian politicians, regulators, and financial institutions, the study's conclusions are highly relevant. First, policymakers and regulators ought to think about revisiting and updating the SEBI guidelines for securitization transactions to conform to the genuine sale doctrine's universally accepted standards, which demand that all ownership be completely transferred to the SPV.

In order to ensure compliance with the Indian legislative framework for securitization and DA transactions, financial institutions should undertake due diligence in the securitization/DA transactions. This will lessen the chance of challenges to the securitization/DA transactions' true sale status and any subsequent legal conflicts.

Thirdly, to address the issues and worries with the Indian legal environment for securitization and DA transactions, policymakers and regulators should think about implementing more thorough and specific laws. This would assure effective market operation, boost investor trust, and support the expansion of the securitization/DA market in India.

IX. Research Limitations and Future Directions

Future studies can address the shortcomings of this study. First of all, future research can expand the analysis to other countries to provide a more thorough understanding of the Indian legal framework for securitization and DA transactions. This study is confined to that analysis.

Second, the study focuses on the legal framework; future research might examine the true sale doctrine's practical application in securitization and DA transactions in India, as well as the difficulties experienced by market actors in upholding the legal structure.

In addition, future research can look at how the true sale doctrine affects the pricing and liquidity of securitized assets in the Indian market, which would give financial institutions and investors important information.

X. Conclusion

Study summary:

With a focus on the true sale theory, the study investigated the idea of bankruptcy remoteness in Indian securitization and DA transactions. It looked at the Indian legal framework for securitization and DA transactions, conformity with international true sale doctrine standards, and problems and issues with the Indian legal system.

Important conclusions and ramifications:

According to the study, the Indian legal framework for securitization and DA transactions typically complies with the true sale concept. In some circumstances, the enforceability of bankruptcy-remote structures raises some questions and presents some difficulties.

The investigation also discovered a framework for guaranteeing compliance with true sale requirements is provided by the SEBI guidelines for securitization transactions. The study's conclusions are pertinent to financial institutions, regulators, and policymakers. To guarantee the enforcement of bankruptcy-remote structures, policymakers and regulators must provide more direction and clarity regarding the legal framework for securitization and DA transactions. When structuring securitization and DA transactions, financial institutions must follow regulatory regulations and best practices.

Contribution to the literature:

By offering a thorough analysis of the true sale doctrine in Indian securitization and DA transactions, looking at compliance with international standards, and highlighting issues and concerns with the Indian legal system, the study makes a significant contribution to the literature. It offers insightful analysis and suggestions for financial organizations, regulators, and politicians.

Concluding remarks and suggestions:

The study's conclusion emphasizes the significance of bankruptcy remoteness in DA and securitization transactions as well as the necessity of a strong legal framework that supports true sale criteria. Financial institutions should follow best practices in transaction structuring, and policymakers and regulators should clarify the legal framework more to ensure the enforceability of bankruptcy-remote frameworks. In order to overcome the study's limitations and explore further aspects of bankruptcy remoteness in securitization and DA transactions, additional research is also required.

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Bankruptcy remoteness in Indian securitisation/ DA transactions

Whether the rules in India, particularly under IBC, clearly exclude third party assets and cashflows, and therefore, we do not have concerns on true sale in India? Whether it is still open for a creditor, claimant or IP to contend that the transaction of assignment is not a true sale at all, and therefore, the asset or cashflows do not become third party asset/cashflows? The question of true sale examined in light of global principles, and Indian law/regulations.

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I. Introduction

Bankruptcy remoteness forms one of the cornerstones of securitisation and direct assignment transactions. An investor in coupons heavily relies on the comfort that the Special Purpose Enterprise/Special Purpose Vehicle issuing the coupons is bankruptcy remote. If the purported securitisation is recharacterized as a secured loan it severely impacts the investor. In event of such recharacterization, the receivables assigned to the special purpose vehicle forms part of the bankruptcy estate of the originator. Furthermore, the special purpose enterprise (SPE) is also not considered a secured creditor for its failure to comply with the registration requirements pertaining to secured interests. Therefore, the investors in the securitised assets are relegated to the status of unsecured coupon holders.

In ordinary course, securitization proceeds on equitable assignment. Legal assignment is relatively uncommon.[1] According to established principles underpinning the law of assignment, only rights maybe assigned. Obligations of the originator cannot be assigned.[2] As a result, obligations in relation to the underlying assets which form the subject matter of assignment continue to vest with the originator. The instrument of assignment cannot transfer any obligation in relation to the assets to the assignee.[3] In normal course, the originator is appointed as the servicer of the loan account by way of a service agreement between the originator and the SPE. In terms of such agreement, the originator services the debt on behalf of the SPE.

The Insolvency and Bankruptcy Code, 2016 (‘Code’) prescribes that third-party assets cannot form part of the insolvency estate of the corporate debtor. Resultantly, the question is whether a securitisation transaction transforms the assets of the originator to that of a third party i.e. whether it can be characterised as a ‘true sale’.

While there are several grounds for potential recharacterization of the securitization transaction, generally, high level of recourse i.e. full responsibility of the originator for the performance of the receivables leads to considerable recharacterization risk.[4] Assignment of receivables with a high degree

[1] Marke Raines and Gabrielle Wong, 'Aspects of Securitization of Future Cash Flows under English and New York Law' (2002) 12(2) Duke Journal of Comparative & International Law 453.
[2] *ICICI Bank Limited vs. Official Liquidator of APS Star Industries Ltd. and Ors.* (2010)10SCC1.
[3] *ICICI Bank Limited vs. Official Liquidator of APS Star Industries Ltd. and Ors.* (2010)10SCC1.
[4] O. Vygovskyy, ‘Re-Characterization Risk and True Sale Principle within the Context of Asset Securitization’ (2019) Global Jurist *20*(1).

of recourse gives an impression that credit risk of the underlying receivables has not passed on to the SPE. Therefore, undermining the principle of true sale.

Assignment of receivables often involves extensive warranties and indemnities by the originator to the SPE. These warranties and indemnities do not automatically give rise recharacterization risk as they are in nature of contractual safeguards in relation to the marketability of the underlying assets. However, being entirely dependent on the originator for enforcement of rights under default may be construed as a high level of recourse. Therefore, the structure of the securitisation must be minutely scrutinised to understand its actual scope and purpose.

There are primarily two forms of securitisation transaction. Firstly, true sale securitisation and second, synthetic securitisation. In case of true sale securitisation, the receivables as well as the related collateral are transferred to the SPV. In contrast, in case of synthetic securitisation only the credit risk is transferred to the SPV and its investors by way of derivative transaction.[5] Synthetic securitisation are not permitted under the Indian securitisation regime.[6]

Courts in United States and other European jurisdictions have generally considered a cumulation of factors in deciding whether to characterize a transaction as a true sale or a secured loan.[7] However, it has been argued that a functional approach that considers the economic reality of the transaction offers a more consistent and logically coherent analysis as compared to the 'factors'-based approach to transaction recharacterization.[8] There is a need to look beyond the form of the transaction and look at the substance of the transaction. Under the instrument of assignment, the creditor must manifest a clear intention to make an irrevocable transfer of the receivable.[9] The Court may recharacterize a transaction when it is found to be a sham whereby the documents do not represent the true intentions of the parties.[10] To the extent that there are informal arrangements between the originator and SPE that represent a departure from what is prescribed in the sale documents, the risk arises that the documents will not be found to represent the intentions of the parties.[11]

The present paper argues that securitisation by way of direct assignment which is in compliance with the relevant guidelines published by the Reserve Bank of India and Central Government should not be recharacterized as a secured loan. The Reserve Bank of India is an expert body to which the responsibility of monitoring the economic system of the country is entrusted.[12] Therefore, recharacterizing a transaction which is otherwise complaint with relevant guidelines published by the Reserve Bank of India undermines confidence in India's banking regulator.

II. Analysis

[5] For a general overview on securitisations and securitisation structures see Wood, 'Law and Practice of International Finance' (2007) Project Finance, Securitisations and Subordinated Debt Pt 2 (Securitisations), 109 onwards.
[6] Reserve Bank of India. Master Direction –(Securitisation of Standard Assets) Directions, Sep 2021, Chapter II: General requirements for securitisation, A(c) <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12165&Mode=0> accessed 05 May 2023.
[7] O. Vygovskyy, 'Re-Characterization Risk and True Sale Principle within the Context of Asset Securitization' (2019) Global Jurist *20*(1).
[8] Harris, Steven L. & Mooney, Charles W. Jr., 'When Is a Dog's Tail Not a Leg?: A Property-Based Methodology for Distinguishing Sales of Receivables from Security Interests That Secure an Obligation' (2014) Faculty Scholarship at Penn Law 1013, 1078.
[9] Marke Raines and Gabrielle Wong, 'Aspects of Securitization of Future Cash Flows under English and New York Law' (2002) 12(2) Duke Journal of Comparative & International Law 453 citing R. M. GOODE, *Legal Problems of Credit And Security* (2d ed. 1988) 111.
[10] Marke Raines and Gabrielle Wong, 'Aspects of Securitization of Future Cash Flows under English and New York Law' (2002) 12(2) Duke Journal of Comparative & International Law 453, 457.
[11] Marke Raines and Gabrielle Wong, 'Aspects of Securitization of Future Cash Flows under English and New York Law' (2002) 12(2) Duke Journal of Comparative & International Law 453, 458.
[12] *Keshavlal Khemchand & Sons Pvt. Ltd. v. Union of India* (2015) 4 SCC 770.

Legal Regime in India

The definition of financial debt of the corporate debtor under the Code includes receivables sold and discounted other then receivables sold on a non-recourse basis.[13] Therefore, sale of receivables while retaining the right of recourse against the seller is a financial debt for the purposes of the Code. Under the Code, the resolution professional must take control and custody of any asset over which the corporate debtor has ownership rights as recorded in the balance sheet of the corporate debtor, or with information utility or the depository of securities or any other registry that records the ownership of assets.[14] Therefore, the receivables and the underlying security interest should not form part of the balance sheet of the originator company post the closing of the securitization transaction. It is however clarified under the Code that the resolution professional/administrator cannot take control and custody of the assets owned by a third party in possession of the corporate debtor held under trust or under contractual arrangements including bailment.[15] Securitisation transaction are predominantly undertaken by financial service providers. Therefore, insolvency provisions relating to financial service providers need to be evaluated. The provisions of the Code relating to the corporate insolvency resolution process of the corporate debtor applies mutatis mutandis to the insolvency resolution process of a financial service provider subject to the modifications made under the rules.[16] The rules in relation of financial service providers clarify that provisions of the moratorium shall not apply to any third-party assets or properties in custody or possession of the financial service provider, including any funds, securities and other assets required to be held in trust for the benefit of third parties.[17] As a result, the provisions of the moratorium in relation to third party assets are not applicable in case of financial service providers. This is because managing third party assets forms a part of the business of the financial service providers.[18]

The relevant guidelines framed by the Reserve Bank of India on securitization mandate that SPE must be bankruptcy remote.[19] The guidelines further mandate that the transferred exposures are legally isolated from the originator in such a way that the exposures are put beyond the reach of the originator or its creditors, even in bankruptcy (specially IBC) or administration.[20] The securitization transaction has to be structured in a manner that originator should not be able to repurchase the transferred exposures unless it is done through invocation of a clean-up call option conducted on an arm's length basis.[21]

In relation to financial service providers undergoing insolvency resolution, the Central Government has also notified the Third-Party Assets Notification.[22] The Notification mandates the administrator of a financial service provider undergoing insolvency resolution to continue to offer services as a servicer

[13] Insolvency and Bankruptcy Code, 2016, s 5(8).
[14] Insolvency and Bankruptcy Code, 2016, s 18(f).
[15] Insolvency and Bankruptcy Code, 2016, s 18 (Explanation).
[16] Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules, 2019, Rule 5.
[17] Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules, 2019, Rule 10.
[18] Report Of the Sub-Committee of the Insolvency Law Committee for Notification of Financial Service Providers Under Section 227 of the Insolvency and Bankruptcy Code, 2016, 15.
[19] Reserve Bank of India, Master Direction – (Securitisation of Standard Assets) Directions, Sep 2021 –G(e)(iii) <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12165&Mode=0> accessed 05 May, 2023.
[20] Reserve Bank of India, Master Direction – (Securitisation of Standard Assets) Directions, Sep 2021 –Chapter VI: Capital requirements for securitisation exposures, B(c) <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12165&Mode=0> accessed 05 May 2023.
[21] Reserve Bank of India, Master Direction – (Securitisation of Standard Assets) Directions, Sep 2021 –Chapter VI: Capital requirements for securitisation exposures, B(b) <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12165&Mode=0> last accessed 05 May 2023.
[22] Ministry of Corporate Affairs Notification, 30 January 2020 <https://ca2013.com/wp-content/uploads/2020/02/Third-Party-Assets-Notification-30.01.2020.pdf> accessed 05 May 2023.

or a collection agent in relation to a securitisation transaction. Furthermore, post the commencement of the insolvency proceedings against the financial service provider the receivables must be deposited in a designated account to avoid co-mingling of assets.

While bankruptcy remoteness of the SPE is an underlying principle behind the extant guidelines it is unclear whether the guidelines are exhaustive as regards conditions to be satisfied for achieving bankruptcy remoteness. Bankruptcy remoteness under the guidelines 'means the unlikelihood of an entity being subjected to voluntary or involuntary bankruptcy proceedings, including by the originator or the creditors to the originator'. Therefore, the content of the guidelines needs to be evaluated. The guidelines prescribe on how the SPE must be organised while undertaking a securitization transaction. The guidelines mandate that the originator and SPE must transact at an arm's length basis.[23] Furthermore, the originator should not have more than one representative, without veto power, on the board of the SPE provided the board has at least four members and independent directors are in majority.[24] However, the question is whether the fulfilment of these criteria is in itself sufficient to achieve bankruptcy remoteness. This part of the analysis examines the issue in more detail.

Understanding the Interplay between Guidelines formulated by the Reserve Bank of India and Insolvency and Bankruptcy Code, 2016 in the context of Securitization Regime in India

The guidelines are silent as to the method of assignment of debts. In most cases, for commercial or practical reasons, the originator does not want notice of the assignment to be given to the underlying debtor. Therefore, securitisations typically involve an 'equitable assignment' of the receivables (by way of a written offer by the seller, with the offer being accepted by conduct of the SPV (as purchaser), such as payment of the purchase price for the assets). Equity recognises such an agreement to assign as giving rise to an equitable interest in the assets in favour of the purchaser, even though all the formalities required by the Transfer of Property Act, 1882 have not been followed.[25]

Where there is a contract between lender and borrower, and lender makes an equitable but not a legal assignment of the benefit of that contract to SPE, this equitable assignment does not put the SPE into a contractual relation with borrower, and consequently, the SPE is unable to exercise directly against the borrower any right conferred by the contract on the lender. The equitable assignment may be converted into a legal assignment by notice to the borrower, but, so long as the assignment remains equitable only, the SPE has no more than a right in equity to require originator to protect the interest which originator has assigned and to do so by exercising the option himself.[26] Furthermore, in the context of securitization equitable assignments suffer from considerable disadvantages.

Firstly, the debtor can satisfy its obligations by continuing to pay amounts to the seller.[27] Second, the purchaser's right to the receivable is subject to any conduct between the seller and the debtor that may give rise to the debtor claiming, for example by way of set-off, that it is not required to repay the receivable in full.[28] Third, the purchaser may have no right to take any action to enforce the receivable

[23] Reserve Bank of India, Master Direction – (Securitisation of Standard Assets) Directions, Sep 2021, Chapter II: General requirements for securitisation, G. Conditions to be satisfied by the special purpose entity.
[24] Reserve Bank of India, Master Direction – (Securitisation of Standard Assets) Directions, Sep 2021, Chapter II: General requirements for securitisation, G. Conditions to be satisfied by the special purpose entity.
[25] *ICICI Bank Limited v. Official Liquidator of APS Star Industries Ltd. and Ors.* (2010) 10 SCC 1.
[26] *General Nutrition Investment Company v Holland And Barrett International Ltd and Anor (Rev 1)* (07.04.2017 - UKCH) citing *Friary Holroyd and Healey's Breweries Ltd v Singleton* [1899] 1 Ch 86.
[27] Berkeley Cox, Ian Edmonds-Wilson, Paul Smith, Chris Trudinger and Scott Heezen, Securitization in John Stumbles (ed.) *Australian Finance Law* (Thompson Reuters, 2016) 267.
[28] Berkeley Cox, Ian Edmonds-Wilson, Paul Smith, Chris Trudinger and Scott Heezen, Securitization in John Stumbles (ed.) *Australian Finance Law* (Thompson Reuters, 2016) 268

against the debtor without joining the seller to the action. Instead, if the underlying debtor defaults and enforcement action is necessary, the purchaser must typically rely on the seller (if it is then acting as servicer), as the party with the legal right to take action against the debtor, to enforce its rights on behalf of the purchaser.[29]

Therefore, equitable assignment restricts the right of enforcement against the principal debtor and consequently the SPE is unable to exercise complete right of recourse. As a result, some argue that securitisations arising out of equitable assignments can be recharacterized as a secured loan.[30]

It has been suggested that in order to mitigate the problem the securitisation documents may require the seller to pay such amounts to the purchaser promptly after receipt, to hold the amounts on trust for the purchaser or to have the seller's account for direct deposit by debtors to be redesignated into the purchaser's name.[31] While such a measure ensures that the originator accounts for the proceeds for the benefit of the SPE it still falls short of providing the SPE complete right of recourse against the principle borrower.

The transfer of all rights and interests (including security interests in case of securitization of secured loans) associated with an asset is indispensable for its characterization as a true sale.[32] The SPV must be able to enforce the receivables and collateral against a defaulted debtor without the participation of the originator, which requires the perfection of title and complying with other formalities.[33] Such formalities are absent in case of equitable assignment.

However, the securitisation guidelines formulated by the Reserve Bank of India stipulate that servicing of the assets by the originator does not detract from the nature of true sale.[34] Therefore, it is arguable that the originator having the right of enforcement does not undermine the principle of true sale. However, it is reasonable to argue that there is a fundamental difference between the originator undertaking enforcement action as an agent of the SPE and when it does so in its independent capacity. In case of a legal assignment, the legal ownership of the assets passes to the SPE, and the originator undertakes enforcement action pursuant to the servicer agreement. In such a case, the originator has no right of enforcement dehors the servicer agreement.

In the context of mortgaged backed securitization, it has been argued that if the transfer of the mortgages is not completed by registration, the SPV acquires an equitable title to the mortgage but the assignor retains the legal title, albeit as trustee for the SPV (assuming, as will usually be the case, that the full consideration has been paid). It has been further highlighted that, for reasons essentially of administrative convenience and cost, transfers by way of securitisation are usually left uncompleted, but with provision being made for completion in certain specified circumstances, e.g. if the transferor persistently defaults on its obligations under the securitisation arrangements. Typically, such obligations will be contained in an 'administration agreement' between the transferor and the SPV.[35] The United Kingdom Court of Appeal has held that when the originator continues to be registered secured creditor under the land registry records it can exercise enforcement rights in respect of the collateral in spite of

[29] Berkeley Cox, Ian Edmonds-Wilson, Paul Smith, Chris Trudinger and Scott Heezen, Securitization in John Stumbles (ed.) *Australian Finance Law* (Thompson Reuters, 2016) 268
[30] Vygovskyy, O., Re-Characterization Risk and True Sale Principle within the Context of Asset Securitization (2019) *Global Jurist 20*(1).
[31] Berkeley Cox, Ian Edmonds-Wilson, Paul Smith, Chris Trudinger and Scott Heezen, Securitization in John Stumbles (ed.) *Australian Finance Law* (Thompson Reuters, 2016) 267
[32] O. Vygovskyy, Re-Characterization Risk and True Sale Principle within the Context of Asset Securitization (2019) Global Jurist *20*(1).
[33] O. Vygovskyy, Re-Characterization Risk and True Sale Principle within the Context of Asset Securitization (2019) Global Jurist *20*(1).
[34] Reserve Bank of India, Master Direction – (Securitisation of Standard Assets) Directions, Sep 2021 <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12165&Mode=0> accessed 05 May 2023.
[35] Ellis Ferran, *Mortgage Securitisation: Legal Aspects* (Butterworths, 1992).

the transfer of beneficial title to the SPV. [36] In the instant case, the originator assigned home mortgages to the SPV, but remained registered in the land register as the mortgage holder. Before the court, the owner argued that only the SPV could enforce collateral. The Court found no merit in the argument and allowed the plea of the originator to repossess the secured asset. Equitable mortgages are not registered in the land registry records. Equitable mortgages arise by way of deposit of title deeds without any formal registration requirements. However, the author feels that the ratio of the judgement is equally applicable in case of equitable mortgages.

The guidelines issued by the Reserve Bank of India are binding on the regulated entities and have statutory force.[37] Therefore, it is debatable the extent to which traditional property law concept can place limitations on the operation of the guidelines. The High Court at Allahabad has also held that assignment of non-performing assets between banks and financial institutions is covered by RBI guidelines, the provisions of Transfer of Property Act, 1882 are inapplicable.[38] While this was said in the context of assignment of debts inter se between the banks there is no reason why the said ratio will be inapplicable in case of assignment of debt to a SPE which is similarly governed by the guidelines formulated by the Reserve Bank of India.

In the face of legal ownership continuing to vest with the originator, to avoid the risk of recharacterization some rating agencies prescribe as a measure of protection for investors that the occurrence of certain events (known as 'title perfection events') require the SPE to perfect its title to the underlying receivables. The SPE would do so by giving notice to the debtors of its ownership of the receivables, requiring that payments be made directly to the purchaser, and (in the case of a mortgage-backed securitisation) transferring the registration of the mortgage over the property from the originator to the SPE at the applicable land titles office. It may need to take these actions under a power of attorney granted by the originator to the SPE at the outset of the transaction. Title perfection events may vary depending, in part, on the credit quality of the originator and the nature of the transaction. Typically, they include the insolvency application against the originator or a failure by the seller to account to the purchaser for the collections on the underlying receivables.[39]

However, perfection of security interest in respect of each mortgage is excessively burdensome and cannot be recommended as a feasible solution to the recharacterization risk. In light of the same, in an application for recharacterization of a securitisation transaction as a secured loan during a insolvency resolution must be resisted. The court must be invited to examine the economic realities underpinning a securitisation transaction. Traditionally, substantive analysis of whether a transfer of receivables by a debtor-originator to a special purpose vehicle constitutes a true sale focuses on the amount and nature of the transferee's recourse against the transferor, or whether the transferor has any right to take back transferred receivables.[40] The guidelines formulated by the Reserve Bank of India permitting securitization provide adequate safeguards against such instances. The rules and notifications of the Central Government on the treatment of third-party assets in insolvency resolution process of financial service providers are aimed at ensuring third party assets are protected and administered smoothly. Moreover, the securitisation industry is predicated on the bankruptcy remoteness of the SPE. Therefore, if the RBI guidelines on securitisation which are aimed at managing conflicts of interest between the originator and the SPE and prevent instances of fraud are followed a bankruptcy court should not cast doubts on the bankruptcy remoteness of the SPE. Applications can however be entertained if there have

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[36] *Paragon Finance plc v. Pender* ([2005] EWCA Civ 760)38.
[37] *Central Bank of India v. Ravindra and Ors.* (2002) 1 SCC 367
[38] Textbook on Transfer of Property Act, 1882 (Lexis Nexis, 6th edn, 2020) citing *Gorakhpur Steels and Metals Pvt Ltd v Presiding Officer, DRT* AIR 2017 All 242.
[39] Berkeley Cox, Ian Edmonds-Wilson, Paul Smith, Chris Trudinger and Scott Heezen, Securitization in John Stumbles (ed.) *Australian Finance Law* (Thompson Reuters, 2016) 268.
[40] Jeffrey M. Carbino, William H. Schorlinga, 'Delaware's Asset-Backed Securities Facilitation Act: Will the Act Prevent the Recharacterization of A Sale Of Receivables In A Seller's Bankruptcy?' 36 Delaware Law Review 367.

violations of the RBI guidelines on securitisation which lead to apprehension of fraud and conflict of interest in relation of the securitisation transaction. Furthermore, applications can be entertained in cases where allegation of fraudulent transfer or undervalued transaction are pleaded. These are important to further the interest of justice. However, questioning the very basis of true sale on the ground that only beneficial or equitable interest in the title of the assets has passed to the SPE is impermissible.

Some have suggested that organizing the SPE as a trust may mitigate the risk of recharacterization.[41] However, while trusts provide more doctrinal basis to ring fencing argument, according to the author, it does little to mitigate the recharacterization risk in the face of equitable assignment. Equitable assignment represents a challenge to the principle of true sale which continues to remain suspect in face of adoption of the trust structure.

The Supreme Court has endorsed securitisation structure and have found the circulars and guidelines issued by the Reserve Bank of India not in conflict with the Transfer of Property Act.[42] The transfer of beneficial and equitable interest of title in the assignee without corresponding vesting of legal rights is expressly permitted under the Transfer of Property Act which do not mandate the requirement of giving notice in the assignment of actional claims.[43] Therefore, non-perfection of security interest and the legal title continuing to vest with the assignor is an insufficient ground to recharacterize a securitisation transaction as a secured loan.

Under the Code, the resolution professional/administrator as the case maybe must take control and custody of the corporate debtor's assets which are under the corporate debtor's ownership. While the originator in a securitisation transaction may continue to be the recorded owner in respect of underlying collateral to the securitised assets the assignment deed must be construed as a deed of relinquishment of its rights over the receivables and secured assets. Therefore, even if the originator continues to remain recorded as a secured creditor under land registry records it cannot claim ownership title over property which it has relinquished.

As has been highlighted earlier, non-fulfilment of notice requirements is not fatal in respect of Indian law pertaining to assignment of debts. Therefore, equitable assignments involving unsecured debt do not face any recharacterization risk. In the context of mortgage-backed securitisation, equitable assignments should similarly not face any inconsistent outcome. It is expected that that non perfection of security interest should not expose such securitisation transactions to recharacterization risk. The ownership in respect of the secured mortgage lies with the principal debtor till time of default. If there is default the originator is mandated in terms of the Central Government notification on Third Party Assets to service the debts on behalf of the SPE. Therefore, the economic realities of the mortgage-backed securitisation transaction also allay any fears of recharacterization risk.

It is therefore argued that a court confronted with an application for recharacterization must necessarily confine its scrutiny to the following:

a) Whether the transaction is compliance with relevant guidelines framed by the Reserve Bank of India?
b) Whether a functional analysis of the transaction reveals it to be a securitisation transaction?
c) Whether there are internal arrangements between the parties that signal a departure from what has been prescribed under securitisation documents?
d) Whether the transaction is fraudulent and undervalued? (This although not a ground for recharacterization it may be entertained while considering a plea for recharacterization).

[41] Berkeley Cox, Ian Edmonds-Wilson, Paul Smith, Chris Trudinger and Scott Heezen, Securitization in John Stumbles (ed.) *Australian Finance Law* (Thompson Reuters, 2016) 258.
[42] *ICICI Bank Limited v. Official Liquidator of APS Star Industries Ltd. and Ors.* (2010) 10 SCC 1.
[43] *M/s. Kotak Mahindra Bank Ltd. v. M/s. Chopra Fabricator and Manufacturers (P) Ltd.* AIR 2011 Allahabad 19.

III. Conclusion

The administrator of an originator company in order to enlarge the bankruptcy estate maybe incentivised to prefer a plea of recharacterization of a true sale as a secured loan. However, if a bankruptcy judge on analysis of the securitization transaction concludes that it is compliant with the relevant guidelines published by the Central Government and Reserve Bank of India it is unlikely that the judge would side with the administrator or resolution professional. At a first glance, equitable assignment of debt may persuade a judge to favour recharacterization. However, a thorough analysis of the transaction and examination of its economic realities is bound to dispel any fears of recharacterization. The guidelines formulated by the Reserve Bank of India on securitisation must be viewed as a complete code and exhaustive on the subject matter and therefore should not be clouded with principles arising from Transfer of Property Act, 1882. Therefore, it is important that the counsel representing the SPE or the investors is able to deftly explain to the judge the features of the transaction for better appreciation of the economic realities underpinning the securitization transaction.

Bankruptcy Remoteness in Indian Securitisation Transactions[1]

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- *Whether the rules in India, particularly under the Insolvency and Bankruptcy Code, clearly exclude third party assets and cash flows, and therefore, do we not have concerns on true sale in India?*

- *Whether it is still open for a creditor, claimant or IP to contend that the transaction of assignment is not a true sale at all, and therefore, do asset or cash flows not become third party asset/cash flows in that case?*

- *The question of true sale examined in light of global principles and Indian law/regulations.*

I. Introduction

Securitisation[2], as the name suggests, is the process by which assets of an entity are converted into marketable securities and passed through a Special Purpose Entity (Hereinafter referred to as 'SPE')[3] to attract potential investors who can then generate cash flow for the entity by investing in these marketable securities.[4] In this way, the illiquid assets of the entity are converted into liquid assets, thus keeping the liquidity of the entity in check and avoiding any instances of cash crunch.

While it may appear to be a straightforward process by a simple reading of its definition, a more nuanced understanding reveals complex layers of statutory, regulatory, economic and legal-principle based interpretation and compliance required for securitisation to be legitimate in nature. The market for securitisation has been understandably wary of its functioning since the Global Financial Crisis of 2008.[5] Regulators around the globe have voiced demands for more systematic, controlled and determinative regulations regarding securitisation. In India as well, the regulator i.e. The Reserve Bank of India (Hereinafter referred to as the 'RBI') has been cautious regarding the ripe nature of the Indian market, to introduce securitisation in a full-fledged manner, with Master Directions for the same being revised as recently as in 2021.[6]

Even though there has been speculation regarding the process of securitisation in the market, it nevertheless comes with a bouquet of benefits. One of these recognized benefits is the aspect of

[1] This paper is original and unpublished
[2] Securitisation is defined under Entry 5 (s) of the Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021.
[3] An SPE is defined under Entry 5 (w) of Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021.
[4] Entity refers to a Bank or a Non-Banking Financial Company (NBFC) for the purposes of this paper.
[5] Several analysis of the Global Financial Crisis, 2008 conclude that a lack of systematic regulation of securitisation was one of the major reasons for the financial crisis.
[6] The RBI issued the "Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021" for this purpose. RBI had also prohibited 'synthetic securitisation' by the way of this Master Direction as it was believed by the regulator that the Indian market is still in the 'developing market' stage to incorporate it as of now.

'Bankruptcy remote' of the securitised assets from the bankruptcy estate of the 'originator'.[7] What this implies is that the third parties' rights (in our case, the investors' rights) will be protected in case the originator go bankrupt, as the securitised assets sold to investors will not be included in the bankruptcy estate of the originator. Other parties like the employees, creditors (secured or unsecured), shareholders etc. cannot claim from these assets. This provides protection, and hence, investors are incentivised to invest in securitised assets. Under Indian law, Master-Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021 (Hereinafter referred to as 'Securitisation Directions) under Entry 5 (a) defines 'bankruptcy remote" as "*the unlikelihood of an entity being subjected to voluntary or involuntary bankruptcy proceedings, including by the originator or the creditors to the originator.*"[8]

In order to deem securitised assets as bankruptcy remote, it must first be established that the transfer of assets from the originator to the SPE was a 'true-sale' and not secured lending. A true-sale indicates transfer of the asset along with all the rights, obligations, risks and rewards related to the asset from the 'seller' to the 'purchaser.'[9] In contrast to this, secured lending works like a loan, where the seller does not transfer all the risks and rewards, related to the assets, to the buyer.

Indian law borrows its standing on this matter from the comprehensive analysis of true-sale of securitised assets developed in American and European jurisdictions, with the RBI establishing that securitised assets must be transferred to the SPE in the form of a true-sale. In the United States, courts have interpreted the contracts for securitisation "as a whole"; they employ a structural interpretation of securitisation contracts to understand the intention of the parities, economic substance and legal consequences of the contract than looking at particular clauses to conclude whether the transaction construes true-sale or secured lending. This method runs the risk of agreements becoming recharacterized by court intervention. European jurisprudence, on the other hand, accords a more liberal interpretation to securitisation contracts. European courts tend to focus more on the rights of the investors, specifically, the undeterred and unqualified right of the investor to the asset securitised in the event of bankruptcy.[10] This has been done by granting multiple security interests to the investors and adopting accounting mechanisms like a matched presentation approach.[11] Thus, the courts do not 'only' rely on true-sale analysis to determine if the securitised assets are bankruptcy remote. In India, though the textual interpretation of the Securitisation Directions and Insolvency and Bankruptcy Code, 2016 (Hereinafter referred to as "Bankruptcy Code) gives the impression that the Indian standing leans towards the American manner of interpretation, the purposive and structural analysis of the Securitisation Directions along with interpretation by the court of law may indicate that India will towards the European method of interpretation. As India's judicial interpretation on this topic is still at its elementary stage, it is difficult to make conclusive remarks. An analysis of the interplay between these laws will provide a roadmap for understanding the future.

This paper aims to *firstly* examine whether the rules under the Bankruptcy Code 'clearly' exclude third party assets and cash flows in a securitisation transaction, making them bankruptcy remote and eliminating concerns regarding true-sale. *Secondly*, this paper aims to analyse whether there can be situations where the creditors, claimants or IP can claim that the securitisation transaction was not a true-sale and hence make themselves a part of the bankruptcy estate of the originator/debtor, stripping their position from that of third-party assets and cash flows. Hence, to establish a base for these arguments, this paper, in its first section, looks into the various underlying factors which determine what

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7 Bankruptcy estate is all the property of the debtor who has filed for bankruptcy in the competent court of jurisdiction. Originator can be understood as the entity which originates the process of securitisation. An originator for the purposes of this paper will be a bank or an NBFC.

8 Master-Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021.

9 Seller is the Bank or NBFC and purchaser is the SPE.

10 This also stems in the fact that in the US, an automatic stay on the assets in possible during the insolvency proceedings while the same is not true for the European context.

11 This is an accounting standard in the UK which is called the FRS 5 in which the assets of the SPE are in the balance sheet of the originator (on-balance sheet) but such asset is netted off non-recourse liabilities and external equity of the SPE.

constitutes a 'true-sale' and into possible instances that can lead to a risk of recharacterisation of agreements between the seller and the buyer. To buttress the arguments made in this paper, relevant Indian law and global principles, in particular the interpretation of the true-sale analysis by United States and European courts, have been relied upon to provide a deeper understanding of the thesis. [12]

II. A legal analysis of factors that go into consideration for determining if a securitisation transaction is a true-sale or secured lending

The true-sale analysis consists of various determining factors which help us understand if a transaction for securitised assets are a true-sale or secured lending. Because there is no definitive list of factors that determine what constitutes 'true-sale' in Indian, US or European law, the matter of its interpretation is left to courts to decide. The judiciary of the aforementioned jurisdictions have not provided for an exhaustive list of factors but have routinely used certain factors in various case laws. What has arisen from giving such power to the court is recharacterisation risk. This means that even though the contract between the seller and purchaser explicitly mentions that the securitisation of the underlying assets is a "Sale" the courts can recharacterise it to be a "secured lending" if upon reading of the contract as a whole, the intention of the parties thus inferred does not indicate a sale on the basis of true-sale analysis.[13] This section looks into what factors courts around the globe have looked into before determining whether recharacterisation should be performed or not and the relevance of such interpretation in an Indian context.

Recourse

There has been much debate with various interpretations and case laws in the US and European courts discussing the role of "recourse" to receivables by the seller as an indicator for the absence of true-sale.[14] It is an argument rooted in the risk-reward analysis of a transaction which states that if the seller has substantial recourse to the assets sold, then they assume most of the risks of the assets, thereby making the transaction a secured lending. In the landmark case of *Major's Furniture Mart, Inc. v. Castle Credit Corporation*, it was held by the court that recourse to assets by the seller alone doesn't determine an absence of a true-sale.[15] It has to be the reading of the agreement as a whole (which indicates the intention of the parties) which must determine the nature of the agreement. However, in declaring so, the court did not lay down any qualifying criteria or procedure through which the relevance of recourse by the seller can be used to characterise an agreement as a true-sale or secured lending.

This part of the paper distinguishes between two types of recourse:

[12] *A brief note by the authors:* Securitisation Directions cover banks, small finance banks (excluding RRBs) and all India Term Financing Institutions. This clarifies that the application of these directions and regulation by RBI can be done only when both the institutions dealing in securitisation are financial institutions. Hence, it has to be noted that all the arguments in this paper have been made with the presumption that two financial institutions are being dealt with.

[13] Kenneth C Kettering, 'True Sale of Receivables: A Purposive Analysis' [2008] 16(511) New York Law School Legal Studies 511-562

[14] Herbert Edelman and others, 'Rethinking the Role of Recourse in the Sale of Financial Assets' [1996] 52 The Business Lawyer 159-198

[15] Major's Furniture Mart, Inc v. Castle Credit Corp., 449 F. Supp. 538 (1978)

1. Recourse to collectability related to the assets and
2. Recourse to economic recourse.[16]

The former can be understood as collectability in the form of a guarantee given by the seller to the purchaser regarding the performance of an asset by establishing a fixed rate of return which is tied directly to the underlying asset securitised. The nature of asset (replaceable or irreplaceable asset) is characterized by usage of the asset as well as no repurchase or buy-backs of these assets being allowed- only the returns of the buyer are affected once the transaction for sale has been executed and in the course of bankruptcy of the originator, the investor is protected from the inclusion of these assets in the bankruptcy estate of the originator. The returns from these assets upon bankruptcy are not limited to the amount of investment or fixed rate of interest, determined at the time of sale transaction.

The latter, i.e., economic recourse is understood from the stand-point of "returns" that may or may not be related to the assets. It deviates itself from the surety by the seller, regarding the quality of assets, to the buyer and concentrates merely on rate of economic return. The characterisation of recourse in these two types helps us understand that when a recourse is merely for collectability, it aligns itself with the true-sale analysis as it is synonymous to a seller not misrepresenting the buyer regarding the soundness of quality of the asset. In *Coast Finance Corporation v. Ira F. Powers Furniture Co.*, the court similarly held that a warranty of soundness of the underlying assets forms conditional sales, which do not deviate from a true-sale analysis.[17] Even on a reading of the Securitisation Directions, it is seen that the law allows for recourse of collectability by stating that credit-enhancement facilities, servicing facilities, maintaining a Minimum Retention Requirement (MRR) etc. by the seller is allowed and do not vitiate the characteristics of a true-sale. This is essentially because these deal with the qualitative soundness of a securitised asset rather than economic soundness. However, when a buyer retains economic recourse to securitised assets, it is more likely that there will be a risk of recharacterisation as this implies that the seller retains more risks with itself and is liable for the losses that arise out of the securitised asset, the reasons for which might or might not be related to the underlying asset, indicating a similar character as that of a loan.

The rationale behind this lies in the contract law and property law principles. The contract law principles recognise the autonomy of contract between freely consenting parties who are competent to a contract, dealing with a lawful object and enforceable in law. This is in line with the agreement between the seller and buyer agreeing on a contract and calling it a "sale" for the purposes of securitised assets being sold. The contract law also recognises the principles of "Unjust Enrichment" which ensures that no party shall be unjustly enriched from the wrongful use of other's property, at the expense of the other.[18] This principle is also the basis for usury laws. The case for not including economic recourse by the buyer under true-sale can be found in the interplay between these two principles as this implies that the buyer cannot receive the benefits of third-party assets/cash flows during bankruptcy of the seller if the seller had retained substantial loses with itself i.e., the buyer cannot unjustly enrich itself by the inclusion of a true-sale clause in the agreement when in reality, the case is something else.

Under the property law principles, it is determined who ultimately has the right to enjoy benefits, take-up liabilities, risks, losses and perform obligations related to the property. An economic recourse by the buyer fails on the application of this principle as well as on the interpretation of such an agreement, it can be understood that it is the seller who retains most of the perils of the property with itself.

There could be instances where there is an intermingling of recourse for collectability and economic recourse in instances where there is partial transfer of receivables sold rather than all the receivables

[16] Heather Hughes, *Property and the True-Sale Doctrine*, 19 J. Bus. L. 870 (2017)
[17] Coast Financial Corporation v. Ira F. Powers Furniture Co., 209 P. 614 (Or. 1922)
[18] Section 70 of the Indian Contract Act, 1872

being sold. This was also the case in *Goldstein v. Madison National Bank and Lyon v. Ty-Wood Corporation*.[19] [20] But surprisingly, the partial nature of transfer of receivable did not bother the court as long as the transfer adhered to the principles of recourse of collectability surrounding those partially transferred receivables. This implies that the courts have indicated a pattern of restricting themselves to a structural interpretation of the assets being sold off and not comparing the same with the assets that have been retained by the seller. Hence, determination of recourse as determining true sale or secured lending is a mix between a subjective and objective test.

Coming to an Indian law analysis of the same, Entry 44 and 45 of the Securitisation Directions provide for facilities supporting securitisation structures. It states that "*Lenders may provide supporting facilities such as credit enhancement facilities, liquidity facilities, underwriting facilities and servicing facilities.*"[21] Entry 44 (f) expressly mentions that there should not be any recourse by the facility provider apart from what has been agreed in the contract. Other provisions under this entry indicate the applicability of the doctrine of separate legal entity, separate legal opinion, fixed nature of the facility provided in terms of time and amount. From the reading of this as a whole, especially the "fixed nature of this facility" shows that Indian law on securitisation leans towards recourse of collectability and not economic recourse. However, there is a lack of procedural clarity on this. This lack of clarity in the Securitisation Directions opens the gate for the applicability of uncertain judicial interpretation. For example; when the doctrine of Separate Legal Entity (SLE) is expressed in these provisions, it fails to account for the fact that the interpretation of this doctrine has not shown uniformity in the Indian courts. This is a classic case of discrepancy in judicial holdings; in the cases of *Balwant Rai Saluja v Air India and State of Rajasthan and Ors. v. Gotan LimeStone Khanij Udyog,* Indian courts applied the doctrine of Separate Legal Entity in two different manners.[22] [23] Therefore, on an analysis there appears to be a lack of procedural certainty and predictability of whether recourse under Indian law will be treated as on par with true sale or not due to a lack of case law development in India on this subject-matter. Such an analysis, therefore, cannot be conclusively laid down and it yet to be seen how it will play out.

Accounting Standards:

Accounting Standards play an important role in understanding whether there was a true-sale transaction between the seller and buyer. As a practice, when the securitised assets are "sold" to the purchaser (transferee) by the seller (transferor), the assets are "Off-balance sheet" transactions i.e., they are no longer mentioned in the balance sheet of the seller.[24] This implies that the seller no longer has any control, risks or rewards related to the asset. On the contrary, when the transaction for securitised assets between the seller and the purchaser is a secured lending, then the assets are "On-balance sheet" of the seller i.e., they are included in the balance sheet of the seller and the seller has retained the risks, rewards, rights and liabilities related to the assets. This accounting standard indicates an "intention" of the parties while entering in a securitisation transaction; whether this intention was to relinquish control and not merely risks and rewards by the seller to the buyer (in which case it would be a true-sale) or to enter into a secured lending agreement where the seller has retained substantial control over the assets

[19] Goldstein v. Madison National Bank of Washington., D.C 807 F.2d 1070 (1986)
[20] Lyon v. Ty-Wood Corporation 239 A.2d 819 (1968)
[21] Master-Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021
[22] Balwant Rai Saluja v. Air India Ltd. (2014) 9 SCC 407
[23] State of Rajasthan v. Goten Lime Stone Khanij Udyog (2016) 4 SCC 469
[24] Thomas Plank, 'The Security of Securitisation and the future of security' [2009] 25(5) The University of Tennessee: Legal Studies Research Paper Series 1656-1736

with it.[25] The control-based understanding of the securitisation transaction traces itself to the anomaly a risk-rewards perspective might carry with it, especially in the case of India, where the law mandates the seller to maintain a "Minimum Retention" of risks with the associated assets, where credit-enhancement facilities, servicing facilities etc. is carried out by the originator.[26] US courts have looked into the Off-balance sheet aspect as one of the important factors in determining the interpretation of a securitised transaction as indeed a "true sale" between the parties.[27] The UK, however, has been cautious to conclusively interpret the nature of a 'true sale' from off-balance sheet transactions.[28] From past experiences, such as that of collapse of Enron where the off-balance sheet treatment to SPEs were used to shirk other liabilities, the UK has proposed the introduction of a matched presentation approach, wherein the SPE will be on the books of the transferor and later be netted off by the external equity of non-recourse liabilities of the SPE.

In India, there have been changes in the accounting standards to attune it to international accounting standards. Changes brought forth by Basel IV norms have prohibited derecognition of assets from the books of the originator if the originator, in their capacity as a service provider, provides for credit enhancement greater than the potential risk associated with the underlying securitised asset.[29] This makes the off-balance sheet treatment of true-sale assets difficult in the Indian context as even if the parties can establish that there has been a true-sale of the securitised assets, an On-balance sheet treatment can still be given to these assets.

This is an issue when we consider the case of the originator becoming insolvent as, if these assets are treated as on-balance sheet transactions, the Indian law on bankruptcy is unclear as to whether these assets will or will not be included in the Corporate Insolvency Resolution Process (CIRP). On one hand, the securitised assets may be included in the CIRP for the sole reason that they are on the balance sheet, while on the other, the courts may investigate the true-sale nature of the securitised assets on the balance sheet. The practicality of this argument is yet to be tested as such a case has not taken place in India as of the time of writing of this paper.

Nature of Special Purpose Entities:

A Special Purpose Entity, as the same suggests, is created by the originator for a special purpose and acts as a pass-through entity between the investors and the originator. The SPE has a Separate Legal Entity, meaning that it is deals with its affairs separate from that of an originator. The independency of an SPE is vital for the investors to ensure transparency and moreover, during insolvency proceedings, it protects the investors' (third-party) assets/ cash flows. Such has also been captured in Entry 3 (w) of the Securitisation Directions which defines an SPE and provides that "*the activities are limited to accomplish the purpose of the SPE and the structure is intended to isolate the SPE from the credit risk of an originator*."[30] Thus, they are supposed to carry on their operations at an "arm's-length" from an originator. This has been provided for under Entry 30 (a) of the Securitisation Directions which provides conditions to be satisfied by the SPE. It is pertinent to note here that SPEs are not 'bankruptcy-proof' but are 'bankruptcy remote'. The usage of SPEs does not take away the jurisdiction of the Bankruptcy

[25] This comes in the wake of a shift from "risks and rewards" based perspective to a "control" based perspective where Off-balance sheet transactions are to be done when substantial control over the asset is given by the seller to the purchaser whereas, if substantial control of the assets is retained by the seller, then it is a secured lending.
[26] Entry 12 in Master-Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021
[27] In the US, SFAS 140 from Financial Accounting Standards Board, USA is followed.
[28] Thomas E. Plank, 'The True Sale of Loans and the Role of Recourse' (1991) 14 Geo Mason U L Rev 287
[29] BASEL IV Norms issued by Basel Committee on Banking Supervision
[30] Master-Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021

court as insolvency proceedings against an SPE can be initiated if it becomes insolvent owing to the investors enforcing security interest and the SPE not being able to pay them. [31]

The role of an independent SPE was recently highlighted in the LTV Corporation Bankruptcy case where the originator, LTV, challenged the securitisation transactions as being "disguised financial transactions" and not a true sale.[32] The court in this case, looked into the nature of the SPE and its activities to interpret and decide that such recharacterisation cannot be done. This shows that once the independence of an SPE is established, all the assets/ cash flows with the SPE are protected from the originator's bankruptcy i.e., are bankruptcy remote thus, protecting third-party rights.

As was noted in the case of *Augie/Restivo Baking Co*., a widely accepted test to determine the independency of an SPE is the test of Separate Legal Entity and analysing when the corporate veil can be pierced.[33] The crux of this lies in the concealment and evasion test, famously laid down in the case of *Prest v. Petrodel Resources Ltd.*[34] For the former, the court is unlikely to pierce the corporate veil as it is related to an individual acting in his individual capacity behind the corporate veil whereas in the latter, there is a frustration of a legal right behind this corporate veil and in such cases, the court is likely to pierce the corporate veil.

After the collapse of Enron, there has been speculation and skepticism regarding SPEs as they were used to escape many other liabilities of the originator, thus creating a doubt regarding the independency of the SPE. Such skepticism is also seen under the Indian law, in the Securitisation Directions under Entry 30 which provides a detailed list of conditions which have to be fulfilled by an SPE. These conditions are indicative of the regulator's intent to establish true-sale of securitised assets by ensuring that an SPE is truly a Separate Legal Entity from that of the originator.

Other miscellaneous factors:

The courts have also looked into a plethora of other factors, some of which deserve a mention for the purposes of this paper.

Firstly, the pricing of the contract- courts have looked into the concept of "fair-market value" and discount to determine if the pricing of a securitisation contract is an indicator of a sale or not.[35] Fair-market value is construed based on the fact that when a property is sold on the basis of true-sale, the pricing and interests for it is in tune with the prevalent market rate. If it shows otherwise, that the originator has securitised assets at an unreasonably right interest rate or the pricing does not meet the reasonability test, it stands a risk of being recharacterised.

Secondly, separate legal opinions obtained by the originator, SPE and investors is considered. This is to avoid any conflict of interest. In furtherance of this, the allocation of the securitised assets in separate accounts by the originator is also considered as an indicator of sale due to an interpretation of separate treatment given to these assets in contrast of other assets with the originator.

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[31] Michael Cohn, 'Asset Securitization: How Remote Is Bankruptcy Remote?' [1998] 26(4) Hofstra Law Review
[32] *In re LTV Steel Company, Inc.*, CASE NO. 00-43866 (Bankr. N.D. Ohio Jan. 6, 2006)
[33] In re Augie/Restivo Baking Co. 860 F.2d 515 (1988)
[34] Prest v. Petrodel Resources Ltd (2013) UKSC 34
[35] Kenneth C Kettering , 'True Sale of Receivables: A Purposive Analysis' [2008] 16(511) New York Law School Legal Studies 511-562

Thirdly, linguistic jargons also play a vital role in interpretation of the intention of the parties as the usage of words like "seller" and "purchaser" rather than "lender/assignor" or "creditor/assignee" indicates a sale.[36]

Fourthly, the clause allowing a repurchase of assets securitised, when a loss is incurred, is interpreted to be a possible secured lending as ideally, an owner of the asset shall bear substantial losses related to the asset, apart from losses that relate to the soundness of the asset or have been guaranteed by the originator. Thus, this section of the paper provides that there is no exhaustive list of factors that can be used to facilitate a true-sale analysis and such analysis is done on a case to case basis by the courts.

III. The Insolvency and Bankruptcy Code, 2016 and protection of third-party assets/cash flows in light of true-sale analysis:

The Bankruptcy Code is a consolidation of various statutes dealing with insolvency of companies, Limited Liability Companies, Partnerships firms and individuals, etc.[37] To examine the applicability of third-party assets/ cash flows under this code, the true-sale analysis becomes important to determine whether these third-party assets will be included in the liquidation estate of the originator/debtor. If it is a true-sale, the assets belong to the third-parties, i.e., they are no longer a part of the liquidation estate of the originator/debtor whereas, if it is a secured lending, then third-party assets can be included in the liquidation estate of the originator/debtor.

To understand the role of true-sale in light of third-party assets/ cash flows during the insolvency/ bankruptcy proceeding of the originator in detail, the relevant parts of the Bankruptcy Code include:

a) A reading of Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules, 2019 (Hereinafter referred to as 'FSP Rules') along with the Ministry of Corporate Affairs notification.[38]
b) A reading of Section 36 (3) with Section 52, Section 53 and Section 36 (4) of the Bankruptcy Code to understand its applicability on third-party assets/ cash flows.
c) Preferential transactions under Section 43 and 44 of the Code.

FSP Rules: Do they protect third-party assets/ cash flows?

While this code aimed at providing a comprehensive law for dealing with insolvency proceedings, it left out Financial Service Providers (FSPs) from its ambit.[39] The repercussions of this exclusion were realised in the cases of DHFL and IL&FS and a need for the RBI to exercise its powers under Section 227 of the Bankruptcy Code was felt.[40] [41] Realising this, the regulator passed the FSP Rules within its

[36] Legal analysis for structured finance transactions (*CRISIL Ratings*, 2023) https://www.crisil.com/mnt/winshare/Ratings/SectorMethodology/MethodologyDocs/criteria/Legal%20analysis%20in%20structured%20finance%20transactions.pdf
[37] Section 2 of the Insolvency and Bankruptcy Code, 2016
[38] Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules, 2019
[39] Mittal, Megha, 'State of Perplexity- Applicability of IBC on NBFCs' (*Vinod Kothari Consultants*) <https://vinodkothari.com/2019/01/state-of-perplexity-applicability-of-ibc-on-nbfcs/>

[40] Dewan Housing Finance corporation Ltd. v. SEBI [SAT Appeal No. 206/2020] < https://sat.gov.in/english/pdf/E2020_JO2020206_10.PDF>
[41] Union of India v. Infrastructure Leasing & Financial Services Ltd. & Ors. [Company Appeal No. 346/2018] < https://www.ilfsindia.com/media/113762/ilfs-judgment-dated-12032020.pdf >

powers accorded to it under Section 227 read with section 239 (zk) of the Bankruptcy Code. However, it is pertinent to note here that these rules cover Non-Banking Financial Companies but do not cover banks.

In analysing these rules with protection of third-party assets/ cash flows, Rule 10 (1) of FSP Rules provides that moratorium under Section 14 read with Rule 5 (b) shall not be applicable on the third-party assets/properties, including any funds, securities and other assets required to be held in the trust for the benefit of third parties, which are in custody of the FSP. Further Rule 10 (2) of these rules provides that the Central Government has the power to specify the procedure for the Administrator to take control and possession of third-party assets held/controlled by the FSP. To provide further clarification on this, the Ministry of Corporate Affairs issued a notification under Section 227 of the Bankruptcy Code specifying the "Manner of dealing with the third-party assets in custody or possession of Financial Service Providers".[42]

The foremost issue with these rules, read along with the notification issued, is that they do not provide for "how" the Administrator will, after taking control of these third-party assets, carry out the entire process of dealing with these assets. It merely states that the Administrator will prepare statements indicating details of these third-party transactions and take on the role of the FSP while ensuring that all these receivables/assets are maintained in a separate account from that of other funds/assets of the FSP. Additionally, the rules do not state how the Administrator will deal with assets/ funds of the third-party which were received prior to the insolvency proceedings. Such broadly laid down duties with no procedural clarity reduces predictability in the process, which is undesirable for an insolvency and bankruptcy procedure where time and costs hold vital roles. The lack of definitional clarity further clouds the predictability aspect of the entire procedure as terms like "*other assets required to be held in the trust for the benefit of third parties"* puts a question mark on what these "other assets" are. For the purposes of this paper, predictability is an important aspect as we are dealing with the doctrine of bankruptcy remote and how it plays out in the application of true-sale analysis of third-party assets/funds. If the investors are aware of the procedure that will be carried out in dealing with SPEs of the originator when the originator is undergoing bankruptcy or insolvency proceedings, they are more likely to invest with lesser hesitation as a clear and well-laid down law and procedure for execution of law provides an incentive for the investors to be certain about their assets/funds being safe and bankruptcy remote in case of insolvency of an originator.

Section 36 (3) read with Section 52 and 53 and Section 36 (4) of the code: Applicability of these sections – Do they provide protection to the third-party assets/ cash flows?

These sections provide an understanding as to what the treatment of third-party assets will be when: 1. There is a true-sale between a seller and the purchaser and 2. When there is no true-sale between the seller and the purchaser and the transaction between them can be characterised as a secured lending.

For the former, the applicability of Section 36(4) is of relevance. It provides a list of assets that shall not be included in the liquidation estate of the debtor. Sub-section 4(i) of this section provides that *"assets owned by a third party which are in possession of the corporate debtor including assets held in trust for any third party"* shall not be included in the liquidation estate of the debtor.[43] The ownership of these assets is a direct question of whether a true-sale existed or not. Hence, if the purchaser can establish that it has ownership over the securitised assets, then the third-party assets/ cash flows are

[42] Manner of dealing with the third-party assets in custody or possession of Financial Service Providers, Ministry of Corporate Affairs Notification dated 30 January, 2020

[43] The Insolvency and Bankruptcy Code, 2016

clearly protected by the virtue of this section. What goes into the determination of a "true-sale" analysis has been discussed in the first section of this paper.

The latter deals with a case where the purchaser is not able to establish its ownership over the securitised assets and hence falls into the realm of a secured lending. In such a case, the purchaser can fall in the realm of Section 36(3)(a) read with Section 52 and 53 which provides for distribution of assets to a secured creditor during liquidation proceedings.

Preferential transactions under Section 43 and 44 of the Code: Is this a sign of worry for the investors?

Preferential transactions, under Chapter III of the code[44], can be another situation which creates further uncertainty in application of true-sale analysis under this code. These transactions entail certain benefits to the creditor, guarantor or surety of the Corporate Debtor in such a way that the creditor, guarantor or surety is in a more beneficial position than they would have been in if assets were distributed under Section 53 of the Code.

Section 43(2) and Section 43 (4) of the Code provides certain conditions, the fulfillment of which provides the creditor (who is an investor, not able to prove true-sale of securitised assets for our case) certain benefits and once these conditions are fulfilled, the look back period is calculated to decide whether the transaction was preferential or not. Further, there are exceptions to these conditions provided for under Section 43 (3) of which, a transfer made in the ordinary course of business or financial affairs of the Corporate Debtor or the transferee, is of relevance. Once this condition is established under section 43 (3), it cannot be forfeited on grounds of it being a preferential transaction. This was the very crux of *Anuj Jain v. Axis Bank Ltd.*[45] Providing a purposive analysis for this, the court created a "deeming fiction", which is a tool often used to remove the need for interpreting the intent of the parties. By laying down this concept, the court in this case, held that once a party fulfills conditions under Section 43(2) and Section 43(4), then the intention of parties is said to be irrelevant for the purposes of interpretation. What is implied was that the "OR" mentioned in Section 43 (3)(a) will be construed and read as "AND". This, the court said, was done by adopting the principle of *Noscitur a sociis*[46]. While giving an explanation to "ordinary course of business or financial affairs" the court said that such an interpretation should include only the core businesses of the corporate debtor.

For our purposes, this is a worrisome situation for the investors. The implication of this can be understood in the following manner: Firstly, the investors are at a risk of losing the ownership over securitised assets as they were not able to prove true-sale of these assets due to lack of certainty in how this true-sale analysis will be done. Secondly, as a result of this, they will be classified as secured creditors due to the securitisation transaction being a mere secured lending.[47] Thirdly, after being declared as a secured creditor, the entire securitisation transaction can be challenged for being a preferential transaction. Such classification will take place on the basis on conditions mentioned under Section 43 (2) and (4) which states that *"if there is a transfer or property or an interest thereof of the corporate for the benefit of the creditor/surety/guarantor for or on account of an antecedent financial debt or operational debt or other liabilities owned by the corporate debtor"* and if the preference transaction is made for a related party during the period of two years preceding the insolvency commencement date. This creates a gray area of interpretation as the other liabilities like retention of

[44] Section 43 to 45 of the IBC provides for Preferential transactions
[45] Anuj Jain v. Axis Bank Ltd (2020) 8 SCC 401
[46] This principle means construing the meaning of an ambiguous/vague word in a statute with context of the entire statute.
[47] This is also subject to the fact that they are able to fulfil the conditions of being a secured creditor under Section of the IBC, 2016 and are able to prove that a secured lending took place

risk, fixed turns, credit enhancement facilities provided by the originator to the investor, could be brought under the ambit of these sections if the court construes it to be under "financial debt or other liabilities" under Section 43 (2). Further issue arises when the sale of securitised assets to the SPE is termed as a related party transaction because of which the independence of the SPE is challenged. Lastly, this risk might result in complete repudiation of the securitisation transaction, leaving the investors in the position of an unsecured creditor or even worse. It remains to be seen how this shall play out in the Indian context.

One more limb of this is under Section 45 and 46 read with section 328 and 329 of the Companies Act, 2013 where a preferential transaction can be declared as "undervalued" or "fraudulent" and declared void. The investor stands at a risk of the securitisation transaction being declared void if it is made within one year from the commencement of insolvency or two years from the period of insolvency if a related-party transaction is established. Hence, in conclusion, there are several uncertain areas in the Bankruptcy Code regarding the true-sale analysis and bankruptcy remote aspect of third-party assets/ cash flows which needs to be addressed.

IV. Conclusion

This paper provides an analysis to understand the connection between the concept of bankruptcy remote and true-sale of securitised assets by looking into the jurisprudence in this field, various underlying global principles, case laws and its relevance in the Indian context. Such an analysis is required to understand what happens to the third-party assets/ cashflows during the bankruptcy of an originator.

This paper provides answers to questions like "Does a true-sale of securitised assets mean they are bankruptcy remote?" "Are third-party assets/ cash flows bankruptcy remote? What does the Indian law say?" "Are there discrepancies in the principles regarding how true-sale should be applied and its actual application?" et cetera.

The interconnectedness between true sale and bankruptcy remoteness has led to courts interpreting the contracts between the seller and purchaser as a whole to understand the intention of parties and various other factors as laid down in this paper. However, this can be a worrisome situation for the investors as there is no set standard or principle to determine when the transfer of securitised assets can be declared true-sale, leaving them at a risk of recharacterisation.

This paper concludes that there are several gray areas in law which need legislative/regulatory clarification, until which it is uncertain as to how the interplay between true-sale analysis and the bankruptcy remote concept in light of third-party assets/ cash flows will play out. As this is a relatively new area, there is not many cases of judicial interpretation of laws as well to provide clarity for the same.

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Covered bonds in India

Covered bonds and potential for structuring transactions of dual recourse in India. European secured notes' structure and potential for using similar structures in India

Covered Bonds and the Potential for Structuring Dual Recourse Transactions in India: The Possibility of Implementing European Secured Notes in the Indian Context

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Covered bonds, also known as bankruptcy-remote bonds or bankruptcy-protected bonds, are considered to be one of the one of the safest investments owing to their substantial asset backing. These financial instruments are construed as hybrid debt instruments since they include a combination of secured corporate bonds, securities backed by mortgages as well as asset-backed securities. Covered bonds, in addition to being backed by a pool of assets, also enable the issuer to transfer these assets to an independent trust that holds them, which gives the bond buyers priority in the event of an issuer's bankruptcy. Both direct payments from the issuer and direct payments from the assets, such as automobile or gold loan repayments, can be used by buyers to recoup their investments. As a result, covered bonds are deemed more creditworthy than regular secured bonds. This research paper aims to explore the potential for introducing covered bonds as a financing instrument in India. In addition, it will also deliberate on the possibility of structuring dual recourse transactions. This paper will also provide an analysis of the structure of European Secured Notes ('ESNs'), the potential for legislative action to regulate ESNs, along with the possibility of using a similar structure within the Indian context. The paper will also examine the possibility of ESNs to become an asset class as well as the degree to which the current prudential and supervisory approach of covered bonds may be applied to ESNs. Overall, the paper will provide a substantive analysis of the potential for structuring transactions of dual recourse in India using covered bonds and European secured notes.

I. Introduction

One of the many funding options available to banks, covered bonds can help banks diversify their funding sources and make asset-liability management easier. The primary distinction between covered bonds and securitisation is the absence of credit risk transfer in covered bonds. The originator still bears the credit risk and must maintain capital (against the possibility of losses), but does so in exchange for often more affordable financing through the issuing of covered bonds. This has an impact on the credit institution's risk management incentives, generally improving the incentives for responsible credit risk evaluation and monitoring. In comparison to securitisation operations, covered bond liabilities and cover pool assets are typically more publicly recorded in the published accounts of banks. Covered bonds, which are essentially debt securities, are issued by financial institutions in addition to being backed by an exclusive group of assets, thereby providing dual recourse to investors. Dual recourse in this context primarily indicates that the investor will have two recourses/options in the event of default: first, on the issuer, and second, on the bankruptcy-protected cover pool. Owing to the many benefits of covered bonds, their volumes are highly likely to increase gradually with greater investor participation and improved stakeholder awareness.

Growth and Proliferation of Covered Bonds in the Indian Context

Covered bonds have significantly transformed the structured finance industry globally since these have also made it through the 2007–2008 global financial crisis. Even within the Indian covered bond market, domestic issuances increased significantly in FY2021 to around Rs. 2,220 crores, from about Rs. 400 crore in FY2020 and a mere Rs. 25 crores in FY2019 having been issued by non-banking financial corporations (NBFCs) – nine in FY2021 as opposed to two in FY2020.1 The Indian covered bond market is still in its early stages of growth but have gained prominence owing to the fact that investors get better yields on their debt investments. In the covered bond transactions that have been observed so far, an Issuer issues Non-Convertible Debentures (NCDs)/Bonds and, in tandem, designates a Special Purpose Vehicle (SPV/Trust) as the security for a pool made up of loan receivables (collateral/cover pool). All of the issuer's rights, title, and interests in the cover pool are transferred to the Trust after assignment, making the cover pool the Trust's exclusive property (and keeping the other creditors of the issuer out of bankruptcy). A Guarantee on the covered bonds is given to the Debenture Trustee by the SPV Trustee (acting on behalf of the Trust). The guarantee's purpose is to cover any gaps in NCD repayment. For the repayment of the Debentures, the trust property, which consists of the cover pool and any additional cash collateral given by the issuer, is pledged as security.

Structured Framework for Covered Bonds in India

A covered bond instrument is a hybrid between a securitisation deal and a secured corporate bond. From a legal point of view, assets held in trust by a corporation for the benefit of an investor will not be included in an entity's liquidation estate under Section 36 of the Insolvency and Bankruptcy Code, 2016.[2] Because of the way covered bonds are structured, rating agencies frequently give them higher ratings than the issuer, a practice known as "credit enhancement." As a result, the issuer can offer these bonds at a reduced interest rate (coupon). These bonds can then be bought by private and institutional investors who demand higher ratings. For instance, even an A-rated issuer can issue covered bonds that get rated 'AA', making them an investment possibility for this investor who only purchases AA-rated bonds. Wealthy people represent a larger market for credit-enhanced bonds because some institutional buyers have restrictions on their exposure to them.[3] Nearly two-thirds of the covered bond issuances so far have taken the form of market-linked debentures. The majority of the issuances have been purchased by family wealth offices and high-net-worth individuals. Investors have taken a liking to covered bonds backed by a security pool of gold loans and auto loans, partly because the underlying loans are secured.

The anticipated remoteness of the cover pool assets from bankruptcy is another appealing aspect of covered bonds. In this context, the term "bankruptcy remoteness" refers to the legal and bylaw restrictions that make it unlikely, if not impossible, for the firm (i.e., its separated assets) to file for bankruptcy in the event that the parent company (let us assume that the issuer bank) does. The "bankruptcy remoteness" of the SPV is crucial for efficient asset segregation when assets are segregated by transferring them to an SPV, which is an off-balance sheet. Off-balance sheet structures therefore need, in a sense, an additional level of segregation, to which legal procedures tried in securitisations are frequently applied. The legal and contractual procedures controlling cover pool "ring-fencing"

[1] ICRA Limited, 'Indian Banks' Covered Bond market to remain limited, need to strengthen regulatory framework for the segment: ICRA', (Press Release, 6 October 2020) available at https://www.icra.in/Media/OpenMedia?Key=b2cac8a1-453b-490c-90ef-7e3b976f6fef accessed 25 April 2023.
[2] The Insolvency and Bankruptcy Code, 2016, §36.
[3] Puneet Wadhwa, 'What explains the sudden surge in covered bonds?', Livemint (9 July 2021) https://www.livemint.com/mutual-fund/mf-news/what-explains-the-sudden-surge-in-coveredbonds-11625505404345.html accessed 1 May 2023.

(reflecting various legal traditions in civil, business, and bankruptcy laws) may also be used to categorise covered bonds. In this regard, a distinction between "on-balance sheet" and "off-balance sheet" covered bonds may be made, i.e., whether the segregation is accomplished through a special purpose vehicle (SPV) to which the assets are transferred or within the issuer's (or a consolidated entity's) balance sheet. Since structured covered bonds are frequently based on SPVs, off-balance cover pools and structured covered bonds are closely related. However, there are also instances of regulated covered bonds based on SPV transactions (such as covered bonds from Italy and the United Kingdom).

Impact of the Reserve Bank of India's (RBI's) Securitisation and Asset Transfer Guidelines on Covered Bonds

The securitisation market in India had seen a significant growth in the early 2000s. However, the global financial crisis of 2008 had a significant impact on the securitisation market in India as well. In response to the crisis, the RBI issued securitisation and asset transfer guidelines in 2012 and revised them in 2021. The updated regulations aim to bring the legal framework into compliance with the Basel standards on securitisation, which took effect on January 1, 2018, and have also been deemed as favourable for the structured finance market. However, according to Fitch Ratings, the majority of the extra items recommended are already taken into account in their analysis of existing transactions, making it credit neutral for rated Indian Asset-Backed Securities (ABS) transactions and also end up stalling the present form covered bond transactions.[4] The asset transfer standards forbid the transfer of assets to an SPV unless they are being used in securitisation and the upfront payment is made in cash. Since the typical consideration from these SPVs is in the form of a guarantee for the covered bonds, this indicates that asset transfers would be challenging for potentially covered bond issuers, thereby making the structuring of covered bonds in their current form more challenging.

II. Dual Recourse in Indian Law: Overview and Application to Debt Instruments

A covered bond is backed by a pool of assets in addition to a cover pool of high-quality collateral (which the issuer is required to maintain) being given to it. For instance, a covered bond could be backed by a pool of gold loans, and the proceeds from these loans will be utilised to purchase the coupon. To protect investors in the event of a default, the bond will also be backed by gold-backed collateral. Investors have a second option thanks to this, which makes the "dual recourse benefit" the "most attractive" aspect of these bonds. Covered bonds have gained more credibility in the Indian market, particularly in H2FY21, according to the ICRA's assessment, as they offer the investor a "dual recourse" benefit, meaning that the repayment obligation must be met by the corporation and, in the event of failure, by a pool of assets assigned to a trust.[5] As opposed to the traditional securitisation of the asset pool, the protection offered to an investor by a covered bond is improved, given the uncertainty surrounding collections as a result of the pandemic. As security for these bonds, the issuer of covered bonds maintains a separate pool of loans. By offering a unique cover pool of assets designated to a trust through covered bond structures, companies and other entities are able to lower the risks for the investors, assisting them in enhancing the credit rating on these covered bonds to AA or AAA rating

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[4] Fitch Ratings, RBI Guidelines Increase Indian Securitisation Transparency; Stop Covered Bonds, (6 October 2021) https://www.fitchratings.com/research/structured-finance/rbi-guidelines-increase-indian-securitisation-transparency-stop-covered-bonds-06-10-2021 accessed 5 May 2023.

[5] Investment Information and Credit Rating Agency ('ICRA'), Indian Covered Bond Market - Emergence of Covered Bonds as an Alternate Fundraising Avenue; Volumes Expected to Pick up with Better Stakeholder Awareness, (June 2021).

categories.[6] As per the 2021 report of the ICRA titled 'Indian Covered Bond Market - Emergence of Covered Bonds as an Alternate Fundraising Avenue; Volumes Expected to Pick up with Better Stakeholder Awareness', an analysis of the rating-wise distribution of covered bonds issued (by value) showed that the ratings of the covered bonds were credit enhanced to higher rating categories, due to the many benefits of the security pool.[7].

The Dual Recourse Benefit to Investors

The dual recourse benefit is an incentivising factor especially since other debt instruments do not necessarily offer the same degree of flexibility to investors. Notably, even in securitisation transactions, the originator does not replenish loan pools once they have been assigned to an investor if the quality of their assets begins to decrease.[8] This risk is substantially mitigated in covered bonds due to the regular substitution of assets that do not comply with the pre-determined pool quality mandate on a regular basis. By varying funding sources, dual recourse instruments could aid in reversing the negative impacts of financial fragmentation in India. By reducing the economic cost of capital in the short term and encouraging the use of standardised and more effective origination and loan pricing processes in the medium term, which results in lower transaction costs, expanding the scope of dual recourse instruments in tandem with restarting securitisation could help mitigate structural constraints on credit supply for attractive prices. The incentives for issuing secured finance instruments are, however, lessened by unfavourable economic conditions in an era of monetary easing and unfavourable cyclical factors.[9]

Incentivising Factors for all Stakeholders Involved in Dual Recourse Transactions

All parties directly involved in dual recourse transactions find covered bonds to be appealing owing for many reasons. Due to the fact that covered bonds often receive a higher credit rating than the issuer's rating, issuers can access less expensive borrowing for longer maturities. Furthermore, the issuing of conventional bonds to the same investor base is made possible by covered bonds, which establish an issuer in the bond market. Additionally, covered bonds offer a variety of funding options.

Enhancement of Credit Rating due to the Benefit of Security of Credit Pool

The dual recourse framework provides additional safeguards to investors as opposed to conventional bond structures. The issuer's credit risk is mitigated to a significant extent by the cover pool assets,

[6] 'Issuance of covered bonds spikes 5 times to ₹2,200 crore in FY21', Livemint (15 June 2021) https://www.livemint.com/market/issuance-of-covered-bonds-spikes-5-times-to-rs-2-200-crore-in-fy21-11624529360248.html accessed 1 May 2023.
[7] Investment Information and Credit Rating Agency ('ICRA'), Indian Covered Bond Market - Emergence of Covered Bonds as an Alternate Fundraising Avenue; Volumes Expected to Pick up with Better Stakeholder Awareness, (June 2021).
[8] Ridhima Saxena, "Covered Bonds: A Liquidity Fix for NBFCs Amid the Pandemic", BQ Prime (30 June 2021) accessed 25 April 2023 https://www.bqprime.com/business/covered-bonds-a-liquidity-fix-for-nbfcs-amid-the-pandemic accessed 28 April 2023.
[9] Andy Jobst, 'The Role of Dual Recourse Instruments for Long-Term Finance in Europe', Hypostat, the Annual Statistical Report of the European Mortgage Federation (February 2015) https://hypo.org/app/uploads/sites/3/2017/04/The-Role-of-Dual-Recourse-Instruments-for-Long-term-Finance-in-Europe.pdf accessed 28 April 2023.

which are usually of higher quality than the issuer's assets. The cover pool is also ring-fenced from the issuer's other assets, which provides further protection to investors.

Lower Cost of Borrowing and Increased Tax Returns

Covered bonds are typically rated higher than their issuer companies and other entities due to the benefit of the security pool, which lowers the cost of borrowing for issuers. When liquidity is still limited, the instrument serves as a good source of affordable borrowing for Non-Banking Financial Companies ('NBFCs') that are well-capitalised but have ratings between BBB and A. Depending on the rating, the perceived credit profile of the issuer, the tenure of the paper, and the quality of the asset pool, the cost of borrowing for NBFCs through the covered bond route typically ranges between 8-11%, which might be between 50 and 150 basis points less expensive than borrowing money by deploying other methods. However, covered bonds may not be an excellent choice for all kinds of NBFCs. Covered bonds are not the first asset that institutions, such as NBFCs or Housing Finance Companies ('HFCs'), that offer longer tenure loans would choose because of the short-tenor character of these instruments.

In addition to this, investors prefer to structure these bonds as market-linked debentures with pay-outs at maturity as opposed to conventional coupon-bearing securities. In addition to having substantially higher yields, covered bonds structured as Market Linked Debenture ('MLDs') offer greater net tax returns than Non-Convertible Debentures ('NCDs') or other available debt products. Although beneficial from a diversified portfolio point of view, covered bonds have an underlying asset-liability mismatch for firms whose regular loan repayment periods are between 5 and 10 years. As a result, these companies would prefer to limit their exposure to covered bonds to no more than a particular portion of their total borrowing.

Lower Coupon Rate at Higher Rating

Due to the improved rating, issuers have benefited from lower coupon rates on covered bond issuances, with coupon reductions ranging from 0.5% to 1.25%. Due to the novelty of the product and the small market size, the coupon rates continue to be higher than the benchmark yield for the upgraded rating category. However, it is projected that as the covered bond market grows in size due to greater investor engagement and improved stakeholder awareness, premiums will eventually decrease.

III. The Legal and Regulatory Framework Surrounding Covered Bonds

From a regulatory framework perspective, a comparison of covered bond regimes demonstrates that, even though EU directives set forth some standard requirements, there are still noticeable disparities between national scenarios for the issue of covered bonds.[10] A number of risk management problems, such as those relating to the kind and calibre of cover pool assets and cash-flow mismatches for issuers, are involved in the issuance and maintenance of covered bonds. Although rating agencies have different methods for grading covered bonds, they are normally rated substantially higher than the issuer's unsecured liabilities. Presently, covered bonds make up a relatively small component of the individual entities' total borrowings. The ability of the corporation to retain the necessary security cover would

[10] European Central Bank, (2008), *Covered Bonds in the EU Financial System*, Frankfurt am Main, December.

still be significant, though, if future issuances rose to the point where covered bonds made up a sizable portion of all borrowings. The covered bond structure's qualifying requirements are typically more stringent than the average for borrowing. In most issuances, there are upper restrictions on the pool's delinquent contracts that could be challenging to sustain during times of stress, such as the time during the Covid-19 outbreak, if a business issues a significant amount of covered bonds.

Additionally, after a trigger event, the cover pool's cash flows would be used to meet the pay-outs of bondholders. Although the trigger event by itself is not necessarily a credit issue, it would also likely cause the issuer's coupon rate to increase, which would have a negative effect on the entity's financial profile. Additionally, the involvement of other types of investors, such as insurance companies and mutual firms, who have the ability to participate in large-size issuances, would continue to be crucial for the covered bond market and could result in significant growth and material increase in the covered bond market. Presently, covered bonds make up a minor portion of the individual entities' total borrowings. Although, an entity's ability to maintain the necessary security cover would still be crucial if future issuances rose to the point where covered bonds made up a sizable portion of all borrowings. Failing to do so would result in a step-up in the coupon rate, which would have a detrimental effect on the entity's financial profile.

IV. Critical Analysis of European Covered Bond Structures along with a Possibility of its Implementation in the Indian Scenario

Covered bonds as a structured financial security are quite popular in foreign markets like Europe. The critical distinction between the Indian covered bond market as opposed to the European scenario regarding the same is that while covered bonds have been issued in India only against short-term to medium-term assets like loans from Micro-Finance Institutions (MFIs), gold loans, personal loans, etc., covered bonds are widely used in the European covered bonds market to refinance long-term assets like residential mortgages, sovereign debt and ships.[11] European Secured Notes ('ESNs') are bonds with a covered bond structure that are used to finance assets that are presently not permitted under the EU law, notably bank infrastructure loans and loans to small and medium-sized businesses.[12] Nevertheless, in an effort to explore if similar instruments can be used by banks to refinance their Small and Medium Enterprise ('SME') loan pools, European regulators are attempting to improve on their methodology of structuring covered bonds. One of the main challenges for the development of the covered bond market in India is the lack of a robust legal framework. Unlike in Europe, where covered bonds are regulated by a comprehensive legal framework, there is no specific legislation governing covered bonds in India. This creates uncertainty for investors and issuers regarding the legal enforceability of covered bonds in case of default.

Similar Structures Comparable to ESNs

While no bonds based on a "ESN law" are now issued in the EU, there are a number of alternative financing options that are comparable to those covered in the current paper. A dual recourse product

[11] Anita Baid, "Has the cover fallen off covered bonds?," Vinod Kothari Consultants (blog), November 9, 2021, https://vinodkothari.com/2021/11/has-the-cover-fallen-off-covered-bonds/.
[12] European Commission, Directorate-General for Financial Stability, Financial Services and Capital Markets Union, *Feasibility study on European secured notes : final report*, European Commission, 2018, https://data.europa.eu/doi/10.2874/904691

supported by SME loans was released by Commerzbank in 2013. Since this was set up according to contract law, it was not given the same legislative protection, supervisory oversight, or favourable prudential treatment as conventional covered bonds. However, it was positively accepted by investors and offered a sliver of a precedent for an ESN.[13] The national central banks in Italy and France have both set up a system to use SME loans as security for open market operations. However, they have not been structured adequately, and banks are also not rewarded with a high advance rate against any particular asset.[14] Turkish covered bond law permits the use of SME loans as security. However, general opinions of sovereign credit among investors suggest that the bond structure of these securities is not a good model for ESNs.[15] SME loans are occasionally used in securitisation transactions as collateral. Since the financial crisis, the issuer has kept a sizable fraction of these transactions in order to use them as repo collateral, however, it is impossible to quantify this due to the market's lower levels of disclosure. Although securitisations are not dual recourse transactions, they can nonetheless be used as collateral and maintained by the issuer. [16] Similarly, a law named Obbligazioni Bancarie Collateralizzate has been approved in Italy that permits SME loans as collateral for dual recourse bond structures similar to covered bonds, however, the enabling regulations have never been finalised; hence the law is inactive.[17]

Analysis of the Structuring of ESNs

In accordance with the structure of ESNs in accordance with dual recourse, the bond must give the investor a claim against the covered bond issuer and in the event of non-payment, a priority claim must be made on the cover pool, subject to the payment of the debt or any other payment obligations. Additionally, the investor will have recourse to the issuer's insolvency estate, which will rank *pari passu* with the claims of the unsecured creditors if the cover pool proves insufficient to satisfy the payments. [18] On the other hand, the cover pool could be registered into a cover register or transferred to a special purpose vehicle (SPV) to achieve the segregation of the asset. Several European countries mandate the registration of covered bonds. The legislative and regulatory framework for covered bonds should stipulate that, in the event of an issuer's bankruptcy or failure, the covered bond programme will be run independently and, in the investor's best interests. This is how the covered bond needs to be administered following an issuer's insolvency.

Nevertheless, it is important to note that in the European Union, especially in jurisdictions like Germany and Portugal, experts have emphasised the need to prioritise out-of-court settlements or agreements in instances involving SMEs rather than subjecting them to an insolvency proceeding.[19] Additionally, the legal/regulatory environment should make it easier for the covered bond's bankruptcy-remoteness by not forcing payments to be accelerated in the event of the issuer's default. The bankruptcy-remoteness

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13 Owen Sanderson, Aimee Donnellan, 'Commerzbank to Boost SME Funding', Reuters (London, 7 December 2012) https://www.reuters.com/article/sme-funding-commerzbank-idUSL5E8N7B1120121207 accessed 1 May 2023.

14 Owen Sanderson, 'France to pilot SME loan securitisation scheme', Reuters (London, 16 May 2013) https://www.reuters.com/article/france-sme-securitisation-idUSL6N0DX46S20130516 accessed 1 May 2023.

15 Nick Lord, 'IFR: Sekerbank readies Turkey's first covered bond', Reuters (London, 1 April 2011) https://www.reuters.com/article/turkey-covered-bond-ifr-idUSLDE7301P920110401 accessed 1 May 2023.

16 Shekhar Aiyar, Ali Al-Eyd, Bergljot Barkbu and Andreas A. Jobst, 'Revitalizing Securitization for Small and Medium-Sized Enterprises in Europe' (International Monetary Fund Staff Discussion Note No. 15/7, May 2015) https://www.imf.org/external/pubs/ft/sdn/2015/sdn1507.pdf accessed 1 May 2023.

17 Bill Thornhill, 'ESNs revived as post-pandemic recovery tool', GlobalCapital (18 April 2020) https://www.globalcapital.com/article/28muavzlbw5ygj8ert7uo/covered-bonds/esns-revived-as-post-pandemic-recovery-tool accessed 1 May 2023.

18 Vinod Kothari, Abhirup Ghosh, 'Use of Dual Recourse Instruments for SME Finance – The Making of European Secured Notes' (Vinod Kothari Consultants Pvt. Ltd., 22 August 2021) https://vinodkothari.com/2021/08/use-of-dual-recourse-instruments-for-sme-finance-the-making-of-european-secured-notes/ accessed 1 May 2023.

19 Uría Menéndez logo, 'Spotlight: alternatives to litigation in Portugal', Lexology (23 February 2023) https://www.lexology.com/library/detail.aspx?g=133cc90f-1021-4594-a662-d51f0b87bf01 accessed 2 May 2023.

of the covered bond needs to be adequately taken into consideration. The cover pool needs to evolve in a dynamic manner, consisting of leasing exposures and non-defaulting SME loans.

The Applicability of Dual Recourse Transactions in the Indian Context

In most European countries, laws that offer bankruptcy protection are in favour of covered bonds. The adaptability of the common law system is used in many different jurisdictions to offer bankruptcy protection. However, the fundamental premise in both scenarios is the same: the cover pool's capacity to act as a backstop for bond redemption in the event of issuer default. To be able to repay the bondholders, the asset pool must be strong and liquid. In comparison to SME loans, mortgage pools that support covered bonds differ significantly. Less granular, more heterogeneous, and with greater historical default rates are SME loans. From the perspective of continuing collections, servicing SME loans is also more complicated than it is for home loans. However, in the end, these are the things that rating agencies will need to take into account when calculating the amount of over-collateralisation and setting the amount of rating notch-ups for covered bonds backed by SME loans. A covered bond structure only seeks to combine the advantages of securitisation and corporate bonds, provided there is a market for the securitisation of SME loans, as evidenced by recent international transactions. Overall, it can be deduced that covered bonds backed by SME loans need to be implemented in India.

To develop the covered bond market in India, the RBI needs to introduce a comprehensive legal framework that governs covered bonds. The legal framework should set out the rules for creating and managing the cover pool assets and provide for the legal enforceability of covered bonds in case of default. A comprehensive legal framework is needed that sets out the rules for creating and managing cover pools, as well as the rights and obligations of issuers and investors. The legal framework should also provide legal certainty for investors and issuers regarding the enforceability of covered bonds in case of default.

The dual recourse framework provided by covered bonds and ESNs could be quite beneficial in the Indian context, specifically with respect to mortgages. Covered bonds and ESNs could provide a more economical source of funding for banks and financial institutions, which could eventually benefit borrowers in the form of lower interest rates. The RBI could consider adopting a structured legal framework similar to the EU directive on a harmonised EU framework for issuing covered bonds, which sets out the rules for covered bonds and ESNs.[20] The legal framework should include provisions on the eligibility of cover pool assets, the segregation of the cover pool from the issuer's other assets, and the role of the cover pool monitor.

V. Concluding Remarks

In conclusion, given the primary characteristics of covered bonds, it is crucial for the sake of financial stability that these markets operate smoothly. In this context, it is vital to keep in mind that covered bonds are a significant source of capital for mortgage lending in a number of jurisdictions. The preservation of the proper functioning of covered bond markets is of great interest to both market participants as well as regulators primarily because covered bonds, just like dual-recourse instruments, are less risky than the majority of other bank securities and have shown themselves to be relatively more resilient during market turmoil. There are various positive impacts which will result from the successful adoption of a dual-recourse instrument for long-term refinancing, particularly of SME lending. Direct advantages include bringing substantial additional capital into the asset class with the

[20] Council Directive (EU) 2019/2162 of the European Parliament and of the Council of 27 November 2019 on the issue of covered bonds and covered bond public supervision and amending Directives 2009/65/EC and 2014/59/EU (2019) Official Journal of the European Union L 328/29.

potential for lower funding costs (for SMEs), improvement of bank balance sheet management for regulators and investors through the use of uniform standards for (SME) loan reporting and transparency, which would significantly lessen uncertainty surrounding bank balance sheets, encouraging increased lending to the sector by increasing Net Interest Margins as a result of lower funding costs along with increasing the accessibility to long-term financing for vital sectors of the Indian economy. This method of successfully implementing a (SME) dual recourse instrument can be used as a model to encourage lending into other macro prudentially underfinanced economic sectors, such as the transition of the global economy to more environmentally friendly energy management. Additionally, while the same can be significantly beneficial to the Indian covered bonds landscape, its implementation needs to be undertaken efficiently in order to ensure the smooth functioning of this bond structure in India.

Covered Bonds and European Secured notes: Innovative financial products with dual recourse to investors and potential for using similar structures in India

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I. Introduction

Structured finance results into addition of unique financial products which suit the needs of investors and fundraisers. Apart from fulfilling traditional objects of mitigation of risks, earning decent returns and efficient use of capital, structured finance ensures fulfillment of complex and composite financial needs of the investors through its sophisticated and innovative methods. Securitization is one such method of pooling of assets and re-packaging them into income bearing securities.

Further, along with the equity financing route, the debt segment has also been a preferred funding option since it provides good returns and envisages measures to ensure security of the principal sum advanced.

Indian Bond markets have witnessed impressive growth with expanding issuer base and product diversity. In the beginning of 2023, the bond market stood at 1.8 trillion USD.[1] With greater infrastructure thrust in the Budget 2023, financing through Bonds will be an attractive option. Bringing innovation in the bond markets is necessary, given the shift of investors towards bond investments. We find such an innovation in structured finance in the bond markets of Europe in the form of Covered Bonds.

II. Covered Bonds

The concept of Covered bonds has European origins and is an important source of funding for European Banks. Since the last few years, the idea of Covered Bonds is gradually taking roots in India. It provides certain added advantages over Secured bonds or asset backed securities.

Meaning/Definition

Covered Bonds are debt instruments issued by banks and financial institutions which are secured by a specific pool of assets which are bankruptcy remote in nature.[2]

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[1] Business Today [Website], https://www.businesstoday.in/markets/story/outlook-2023-bond-market-could-be-the-opposite-of-2022-heres-why-357575-2022-12-23 (accessed 5 May 2023).
[2] Scripbox [Website], https://scripbox.com/pf/covered-bonds/ (accessed 3 May 2023).

Specific pool of assets includes the pool of loans provided by the bank or NBFCs say home loans, auto loans, gold loans etc.

In case of traditional secured bonds, the bondholders have a recourse only against the issuer of the bonds, if there is a default in the payment of interest.

Whereas, Covered Bonds provide a Dual Recourse- both against the issuer of bonds as well as the specific pool of assets. In order to achieve such a dual recourse, a distinct entity referred to as a Special Purpose Vehicle or SPV is created.

Transfer to an SPV

The legal title of the identified cover pool of assets is transferred to such an SPV by the issuer of bonds. It is to be noted that there is no true sale or actual sale of the said pool of assets from the issuer to the SPV. But, only the legal title of the covered pool of assets is transferred.

The covered pool and the liability towards the investor remains on the balance sheet of the issuer itself. Due to this structure, the cover pool of assets is exclusively available for the bondholders.

Thus, a dual recourse is created- one against the issuer and second against the asset pool transferred to the SPV. This structure acts as an additional insulation or risk cover for the investors.

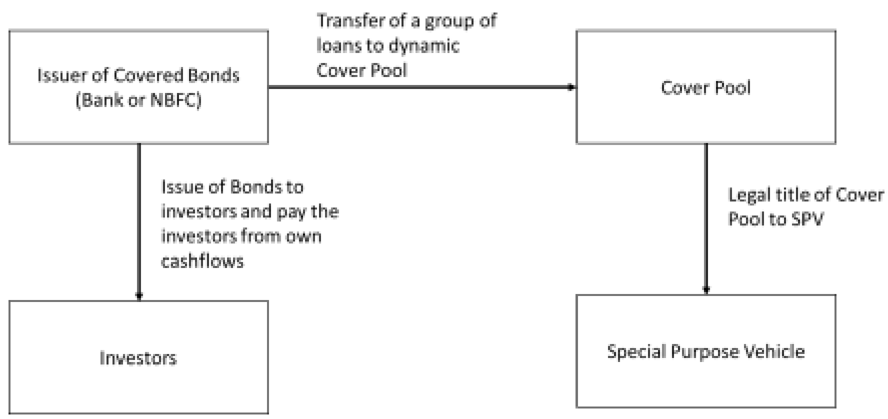
Failure to pay the interest by the issuer or failure to repay the bonds on the agreed timelines of maturity (denoted as Standard Maturity Date) is referred to as trigger event. On such an event, the cover pool becomes static and the double recourse mechanism will set in.

Structure of Covered bonds

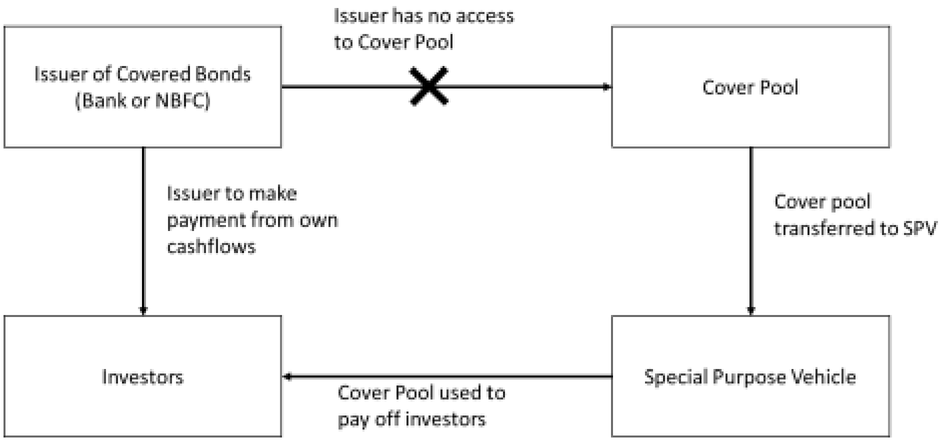
Initially, the interest and repayment of these bonds is done by the issuer from his own funds separate from the cover pool.

In case of a trigger event, i.e. inability of the issuer to pay the interest and principal, the assets in the cover pool are utilized for meeting the investor obligations. Further, the investors have a claim on the issuer itself for any residual losses. To appreciate the structure well, the same are presented in a diagrammatic manner below:

<u>Structure of Covered Bonds</u>



Post occurrence of a Trigger event



Types of Covered bonds issue

Covered Bonds can be bifurcated into 2 broad categories-

i. Legislative Covered Bonds- There are the bonds wherein the State brings in a specific piece of legislation governing covered bonds.
For instance- Germany, Spain, Denmark, France, United Kingdom, Singapore, New Zealand, Canada and so on are Countries where some form of legislation is brought in for issuing covered bonds.

ii. Contractual Covered Bonds- No separate law is enacted and bonds are issued by means of an independent contract. For instance- India.

Dynamic cover pool

Another feature is that the cover pool is dynamic in nature to ensure maximum safety for the investors. Thus, if a few of the assets in the cover pool turn bad, they are replaced with the loans which have a good credit history. This ensures additional safety to the investors.

Over collateralization

The other feature of these bonds is the degree of over collateralization. It is a process of introducing collateral that is worth more what is sufficient to cover potential losses in cases of default.

Market linked returns

The returns on such bonds i.e. interest is lined to the rate of market linked debentures or MLDs. MLDs are nonconvertible debentures whose returns are not fixed but linked to an underlying market index. The underlying index could be equity benchmark, government yield, gold index, etc.

Bankruptcy remoteness:

One of the most crucial features of Covered Bonds is its bankruptcy remoteness as compared to the issuer. Where a legal title of the cover pool is transferred to a separate SPV, this ensures bankruptcy remoteness in a trigger event. This feature is subject to State specific legislations, but to a certain extent, it may be achieved through contractual agreement as well.

Credit rating[3]

Credit rating is the other key aspect of covered bonds. From an international perspective, covered bids enjoy a comparatively higher credit rating, given its additional safeguards in terms of double recourse, over collateralization and Bankruptcy remoteness.

Accounting aspects of covered bonds

From an accounting perspective, the transfer of covered pool of assets from the issuer to the SPV is transfer of legal title, also referred to as a true sale. So, the covered pool still remains in the balance sheet of the issuer but the legal title is transferred to the SPV. Thus, covered bonds per se do not generate an off-balance sheet asset.

III. Covered Bonds in European markets

As stated earlier, this concept of covered bonds is in vogue for about 200 years in some or the other format in Europe. After the sub-prime crisis of 2007-08, the present form of covered bonds gained a momentum in Europe.[4] A huge growth was seen in Covered bonds issues in 2022. Further, European investor-placed covered bond issuance exceeded €73 billion in Q1 2023 which is the highest level since 2012.[5]

Majority of issues of Europe are through Legislative Covered Bonds wherein directives and legislations are in place for such issues.

IV. Current position in India

When we analyze the position of covered bonds in India, there is no specific legislation governing these issues. Further, the existing legislation governing capital market does not distinctly incorporate Covered Bonds. Given the same, Covered bonds in India are only issued based on a separate contract, governed by the provisions of the Indian Contract Act, 1872.

[3] CRISIL Ratings Criteria for rating covered bonds October 2022 https://www.crisil.com/mnt/winshare/Ratings/SectorMethodology/MethodologyDocs/criteria/crisils%20criteria%20for%20rating%20covered%20bonds.pdf ,(accessed 3 May 2023).

[4] European Covered Bond Council [Website], https://hypo.org/ecbc/covered-bonds/, (accessed 3 May 2023).
[5] Global Covered Bond Insights Q2 2023: The Implications of Rising Interest Rates April 12, 2023 https://www.spglobal.com/_assets/documents/ratings/research/101575277.pdf, (accessed 3 May 2023).

As discussed earlier, given the infrastructure thrust in India, bond markets will be an attractive option for India and there is a need for innovation in bond products. As of now, one can say that the Covered bonds in India are at a budding stage.

In India, the National Housing Bank (NHB) presented a detailed working paper in October 2012, inter alia including certain proposals to introduce covered bonds in India.[6]

Statistically speaking, in India, there was a significant rise in issuance of covered bonds in 2021-22, where the numbers increased to Rs 22 billion as opposed to Rs 4 billion in 2020-21. When compared to the total corporate bond market size of Rs 3.72 trillion, one may safely conclude that covered bonds in Indi are in pretty much a nascent stage.

V. Prospects of Covered Bonds in India

While discussing the prospects and viability of covered bonds in India, the following areas may be discussed:

Success rate of Covered Bonds in Europe

One of the important reasons to advocate issue of covered bonds is its stellar history in terms of no major default in last 200 years. There have been 6 instances of bankruptcies, but in these cases there was a timely interference of the market regulators and such covered bond assets were transferred to larger banks.[7]

Apart from these instances, there is no example of a systemic collapse due to as a result of these bonds.

Regulatory changes under SARFAESI, IBC, SEBI/RBI Rules, Company law from perspective of bankruptcy remoteness and classification

Bonds are covered broadly under section 2(30) of the Companies Act, 2013[8] under the definition of debentures as-

> *"(30) debenture includes debenture stock,* ***bonds or any other instrument of a company evidencing a debt****, whether constituting a charge on the assets of the company or not;"*

Even section 2(h) of Securities Contracts (Regulations) Act, 1956[9] includes bonds under the definition of securities-

[6] Working Group for promoting RMBS and other alternative Capital Market Instruments - Covered Bonds National Housing Bank October, 2012 Report and Recommendations, https://nhb.org.in/Whats_new/NHB%20Covered%20Bond%20Report.pdf, (accessed 3 May 2023).

[7] Working Group for promoting RMBS and other alternative Capital Market Instruments - Covered Bonds National Housing Bank October, 2012 Report and Recommendations, https://nhb.org.in/Whats_new/NHB%20Covered%20Bond%20Report.pdf, (accessed 3 May 2023).

[8] The Companies Act, 2013 https://www.mca.gov.in/Ministry/pdf/CompaniesAct2013.pdf (accessed 3 May 2023).

[9]SECURITIES CONTRACTS (REGULATION) ACT, 1956 https://www.sebi.gov.in/acts/contractact.pdf (accessed 3 May 2023).

*"(h) "securities" include— (i) shares, scrips, stocks, **bonds**, debentures, debenture stock **or other marketable securities of a like nature** in or of any incorporated company or other body corporate;"*

Since, covered bonds are a type of secured bonds with additional features, we may reasonably assume that they are a part of the existing jurisprudence on securities wherein the general category of instrument evidencing a debt or debt securities of a like nature are also covered.

Coming to the provisions of Insolvency and Bankruptcy Code, 2016[10], [IBC, 2016] it is a separate legislation governing Insolvency matters. Therefore, IBC, 2016 will override the general laws in this regard.

For issue if a covered bond, even though a separate entity may be carved out under a contractual agreement governed by general principles of Contract Act, it cannot effectively ring fence this separate entity in the event of bankruptcy in a manner contrary to IBC, 2016.

Bringing covered bond holders at a *pari passu* stake as compared to other secured creditors will require a legislative amendment to the IBC, 2016.

Section 53 of the IBC, 2016 deals with distribution of assets. The relevant extracts are re-produced below:

"53. (1) Notwithstanding anything to the contrary contained in any law enacted by the Parliament or any State Legislature for the time being in force, the proceeds from the sale of the liquidation assets shall be distributed in the following order of priority and within such period and in such manner as may be specified, namely :—

(a)…;

(b) the following debts which shall rank equally between and among the following :—

(i) workmen's dues for the period of twenty-four months preceding the liquidation commencement date; and

*(ii) **debts owed to a secured creditor** in the event such secured creditor has relinquished security in the manner set out in section 52;*

(c) wages and any unpaid dues owed to employees other than workmen for the period of twelve months preceding the liquidation commencement date;

(2) Any contractual arrangements between recipients under sub-section (1) with equal ranking, if disrupting the order of priority under that sub-section shall be disregarded by the liquidator."

Thus, it can be observed that debts owed to a secured creditor are equally ranked with workmen dues. Further, under the category of secured creditors, there may be other financial creditors apart from bond investors.

An amendment to give place covered bond holders in priority will result into a conflict of interest of various stakeholders.

Further, given that the covered bonds are at a budding stage, providing a legislative preference may not be a viable option as of now.

[10]The Insolvency and Bankruptcy Coe of India, 2016
https://www.mca.gov.in/Ministry/pdf/TheInsolvencyandBankruptcyofIndia.pdf (accessed 3 May 2023).

Thereafter, sub section 2 specifically discards any contractual agreement in contradiction to the one mentioned u/s 53(1).

Since IBC, 2016 is a self-contained code, the next pertinent question is whether an amendment in SARFAESI Act, 2002[11] will be of some assistance.

SARFAESI Act is a law that allows Indian banks and financial institutions to sell or auction the assets/properties of credit defaulters without any intervention from the courts.

Extracts of section 13 of the SARFAESI Act, dealing with enforcement of security interest are re-produced below:

> (2) ***Where any borrower, who is under a liability to a secured creditor under a security agreement, makes any default in repayment of secured debt*** or any instalment thereof, and his account in respect of such debt is classified by the secured creditor as non-performing asset, then, the secured creditor may require the borrower by notice in writing to discharge in full his liabilities to the secured creditor within sixty days from the date of notice failing which the secured creditor shall be entitled to exercise all or any of the rights under sub-section *(4)*.
>
> Provided that-
>
> *i.* ***the requirement of classification of secured debt as non-performing asset under this sub-section shall not apply to a borrower who has raised funds through issue of debt securities****; and*
>
> *ii.* *in the event of default, the debenture trustee shall be entitled to enforce security interest in the same manner as provided under this section with such modifications as may be necessary and in accordance with the terms and conditions of security documents executed in favour of the debenture trustee.*

For taking recourse under SARFAESI Act, the secured debt should have been classified as a non performing asset. But, this requirement as per the proviso highlighted above, is not applicable to debt securities.

So on a trigger event, a secured debt may be enforced and amount may be recovered. SARFAESI may be suitably amended to include covered bonds as a category.

The main intent of SARFAESI is to attach and sell off or auction secured debts for recovery of money. Under the dual recourse model, the covered pool in case of trigger event becomes exclusive property of the investors and the balance if any to be borne by the issuer.

Where the remedy of SARFAESI is taken recourse to, a possibility that the issuer will attempt to take the appellate route under SARFAESI Act cannot be ruled out. This will lead to further litigation and delay in the payments to the investors.

Segregation of the cover pool from the issuer to an SPV may be facilitated by virtue of a contract to that effect, but when it comes to actually making the SPV with the covered pool a bankruptcy remote entity, there are legislative hurdles involved in the process.

As of now, the only assurance that may be provided by covered bonds is an additional safety valve due to over collateralization.

[11] India Code [Website] https://www.indiacode.nic.in/handle/123456789/2006 , (accessed 3 May 2023)

True sale of cover pool

The aspect of true sale of covered pool of assets to the SPV and the said assets still remaining on the balance sheet of issuer lead to further challenges in ensuring bankruptcy remoteness. In this regard, it is difficult to envisage or recognize a true sale along with full recourse.

There are two schools of thoughts in this process- one is substance over form wherein the term true sale has to be construed as per the substance of the transaction i.e. rights and obligations created. The other is intention of the parties would thrive thus considering form over substance.

Reference may be drawn to a USA Court ruling in the case of In re George Inglefield Ltd. [1933] Ch 1, where the distinction between true sale and a secured loan has been given as below[12]:

- In a sale, the seller is not entitled to get back the sold assets by returning the purchase price to the buyer, whereas a loan secured by a mortgage or charge of the asset would include such a right.
- If a mortgagee sells the secured asset for an amount in excess of the outstanding balance of the loan, it would have to account to the mortgagor for any surplus, whereas in a sale transaction, if the buyer subsequently sells the asset for a profit, it does not have to account to the original seller for the profit.
- If a mortgagee sells the secured asset for an amount that is insufficient to discharge the outstanding loan balance, the mortgagee is entitled to recover the balance from the mortgagor, whereas in a sale transaction the buyer of the asset will have no right to recover any shortfall from the seller where the buyer has on-sold to a third party for a loss.

Thus, it is discernable that transfer of risks and returns is crucial to determine sale in a general parlance.

But, at the same time, the intention of parties is also an important factor that has to be taken into account. The language used in any contract should convey the intention of parties. The intention of parties in a covered bond arrangement may be that the investors have full recourse to the covered pool of assets in the SPV even though the same remains on the balance sheet of issuer. The clarity of reference in the contract or the document is the key factor in such a case.

Being a new bond variant in India, chances cannot be ruled out of the Indian regulators adopting substance over form with respect to covered bonds since public money will be at stake.

Taxation of covered bonds

From an investor perspective, taxation is one of the key drivers for decision making. While attractive returns and manageable risks still are the basic barometers, tax consequences also have to be monitored.

Covered bonds unlike normal bonds yield returns as per the market linked debentures (MLDs). Thus, from a taxation perspective, the covered bonds are to be treated as MLDs.

MLDs being capital assets, would be subject to capital gains tax. As per section 2(42A) of the Income-tax Act, 1961[13], holding period for capital gains purposes would be 12 months. So, where a bond is held for more than 12 months, Long-term capital gains at 10% will be applicable on such covered bonds, whereas the short-term capital gain are taxable at the applicable slab rate of the investor.

[12] Mayr Brown [Website] https://www.mayerbrown.com/en/perspectives-events/publications/2020/04/trade-finance-insolvency-and-business-disruption-implications ,(accessed 3 May 2023).
[13] Income tax Department, Government of India [Website], https://incometaxindia.gov.in/pages/acts/income-tax-act.aspx, (accessed 3 May 2023).

But, the latest Finance Act, 2023 brought in certain amendments to this section. The Finance Act, 2023 has inserted a new section 50AA effective w.e.f. 1.4.2023, providing that any gain arising on transfer of MLDs, on or after 1.4.2023, will be deemed to be treated a short-term capital gain and will be taxable at the applicable tax slab rate of the investor and not as long-term capital gain and taxable at a reduced tax rate of 10%.

Since Market linked debentures were a tax effective strategy for high net-worth individuals, this amendment seeks to plug that loophole. But, since covered bonds are also linked based on the MLDs, the parallel tax impact will be borne by such bonds as well.

The Asset transfer guidelines by Reserve Bank of India (RBI)

The next aspect to be considered is the Asset transfer guidelines introduced by the RBI in 2021. On 24 September 2021, the RBI brought in certain guidelines for Securitization of Standard Assets[14]. Certain conditions were imposed for transfer of assets to a SPE or Special Purpose Entity.

The Rules provide for a cash settlement when the asset pool is transferred to an SPV, an extract of which is as below:

> *"**Originators shall sell assets to SPE only on cash basis and the sale consideration should be received not later than the transfer of the asset to the SPE**. Further, there should not be gap of more than 30 days between transfer of the assets and the issuance of securitisation notes."*

This per se does not prohibit covered bond issues but does set a precedent that an asset transfer to an SPV is contemplated on a cash settlement basis by the Indian Central Bank which is not the case with Covered Bonds.

VI. Risks associated with Covered Bonds

As a prudent investor, it is also necessary to analyze the risks associated with covered bonds. Even though the covered bonds have a fantastic track record over 200 years in European Markets, there are certain area we need to look into.

The first aspect is that these bonds are based on a credit rating arbitrage. One of the incentives for marketing these bonds to investors is the higher credit rating offered based on the double recourse model and over collateralization. The higher credit rating is provided based on assumptions of these promises fulfilled. Where there is a hurdle in implementing the advantages, it will result in downgrading of bonds and a loss of credibility in the markets.

One of the features of covered bonds is over collateralization. This process leads to shift of good loan books for a defined niche of investors. In the event of a liquidity crisis or any trigger event, parking excess of good loans for a group of investors puts pressure on other secured and unsecured creditors.

The next aspect is of assets and liability mismatches. Even though over collateralization and dynamic cover pool is ensured, proper monitoring of the loan books is necessary to ensure servicing of returns to the investors. If an entity issued huge covered bonds maturing within the same period, the resulting redemption would lead to a liquidity crunch if not managed properly.

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[14] Reserve Bank of India [Website] https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12166, (accessed on 5 May 2023).

VII. European Secured Notes

It may not be an overstatement to say that the future of finance will be inextricably bound to innovation. Abiding by this statement, Europe came up with another innovation in structured finance following the building blocks of Covered Bonds which is – European Secured Notes. European Secured Notes or ESNs are similar to covered bond structure wherein the bond issue is primarily backed by small and medium sector loan or MSME loans[15].

Such ESNs are either structured as asset backed securities where assets are MSME loans. Secondly, they are also structured through a covered bond wherein the pool of assets would be MSME or SME loans (Small and medium enterprises).

The structure being similar to that of covered bonds, the caveats of the covered bonds structure will also apply to ESNs. One of the differences in the features is that the level or the extent of over collateralization is fixed in this case, which is recommended up to 30%. Further the eligibility criteria for the MSME loans would have to be defined so that the cover pool should comprise of dynamic and non-defaulting MSME loans.

The positives are that the MSME sector is a promising sector and refinancing of such loans would cater to financial needs of MSME and lead to economic development.

But prima facie ESNs appear to be instruments with restrictive cover pool with less diversification i.e. only MSME loans. The ESNs are a post coronavirus disease (COVID-19) Phenomenon in Europe to revive SME sector. But one needs to be mindful before refinancing risky loans without adequate research and analysis else it may result in a long-term crisis for MSME sector in India.

Even speaking of India, the MSME sector has been one of the worst hit sectors. As of August 2022, the MSME sector in India faced a credit gap of INR 20-25 Trillion against an outstanding amount of INR 22.3 trillion.[16]

Post COVID-19, the theory of helicopter funding i.e. spending huge amounts for boosting economy and inflation was propagated world over. If that model is applied to MSMEs for revival, it may not be a viable idea since this refinancing liquidity will create temporary bubbles in the economy.

VIII. Concluding remarks

Given the budget thrust on long term expenditure, bonds are an attractive option of funding. Further, the need of innovation and democratization of bond issue is also being underlined. Covered bonds, because of its obvious advantages of a double recourse, bankruptcy remoteness and higher security, becomes one of the options under consideration.

From an Indian perspective, to achieve bankruptcy remoteness, there are certain legal challenges that need to be countered. Further, the overall Government guidelines, more particularly with respect to an asset transfer to SPV do not seem to be going much in favour of recognizing covered bonds.

Successful implementation will require support from Government in terms of bringing in a legislation. The search paper of 2012 by NHB brings out a very comprehensive picture giving useful suggestions

[15] Economic Times [Website] https://economictimes.indiatimes.com/industry/banking/finance/banking/banks-reach-out-to-rbi-seek-easing-of-msme-bad-loan-rules/articleshow/98923918.cms ,(accessed 3 May 2023).
[16] BFSI.cm [Website], https://bfsi.economictimes.indiatimes.com/news/financial-services/msmes-growth-doubles-in-last-2-years-credit-gap-remains-report/96221758, (accessed 3 May 2023).

for trying some innovation in the bond markets. A Committee needs to be formed by the Government with inputs from RBI and SEBI to assess the viability of covered bonds with an Indian flavor.

At the same time, the risks involved need to be assessed in terms of credit rating arbitrage and possibility of high-risk ventures being lent huge amount of funds resulting into bankruptcy or the effects of over collateralization on the rest of the portfolio of the issuer.

Before bringing in subject specific legislations, more brainstorming into the viability of Covered Bonds as a structuring alternative is necessary.

With regards to an ESN like structure backed by MSME loans, a proper risk analysis of the covered pool and the overall health of MSME loans needs to be assessed.

Bonding for success:
A comparative analysis of Covered Bonds and its potential for structuring transactions of dual recourse in India

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The Covid-19 pandemic had an unanticipated positive impact on India's bond market, consequently, a surge in the issuance of covered bonds was reported. FY21 observed an issuance of Rs. 2,220 Crore worth of covered bonds by Indian Issuers. Despite the sudden growth, the legislation and market-awareness surrounding covered bonds has a long path paved ahead of itself to find success.

The author, through this research paper aims to provide a coherent understanding of the covered bond market in India by analyzing the impact of covered bonds in the India and analyzing the trend of covered bond issuance. The paper in this section also highlights the role of covered bonds in strengthening the fixed income market of India. The paper, in the second section, analyzes the introduction of Structured Notes ('ESN') in the European framework following the concept of covered bonds. The paper in this section also attempts to draw a comparative analysis of the framework adopted by the European Union and India. The paper then concludes by suggesting a way forward for the Indian covered bond market.

I. Introduction

Covered bonds are issued by banks or Non-Banking Financial Company ('**NBFC**'); these bonds are backed by collateral pools,[1] also referred to as cover pools, which are comprising of: *firstly*, private sector loans (mortgage or residential loans); or, *secondly*, public sector debt instruments (loans or debt securities). It can be construed that covered bonds are a synthesis of secured corporate bonds and asset-backed securities/mortgage-based securities ('**ABS/MBS**').

However, there exists a stark difference in the recourses that are available through covered bonds. ABS/MBS merely provide a security against collateral pools, however, in addition, covered bonds also provide a recourse against the issuer.[2] Secured corporate bonds provide a security against the issuer, however, covered bonds, take a step further and provide bankruptcy-remoteness against the assets of the issuer. Therefore, covered bonds stipulate a dual recourse for the investors: *firstly*, against the collateral pools; and *secondly*, against the issuer.

Introduced approximately 250 years ago with the system of Pfandbrief, covered bonds have proved to be an important source for market-based funding for European countries to build an efficient capital market.[3] Even though, covered bonds have primarily been a method for refinancing public sector debts in Europe, they are now being adopted by different countries to strengthen their capital market structure.

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[1] European Central Bank defines collateral pools as "a method of collateralization that allows an organization to provide collateral to a counterparty without assigning it to a particular transaction."
[2] Liberadzki, K. (2015). Covered Bonds in Europe: Issuing and Markets. *Economics*, *3*(9-10), 209-220.
[3] Schwarcz, S. L. (2010). The conundrum of covered bonds. *Bus. Law.*, *66*, 561.

In March 2007, Bank of America made its first covered bond issuance. [4] Subsequently, the first instance of covered bond issuance, backed by vehicle loans, in India was observed recently in FY 2019.[5]

The covered bond market, thereof, has seen a steady growth and has, therefore, attracted new investors and issuers. The Covid-19 pandemic had an unanticipated positive impact on India's bond market, consequently, a surge in the issuance of covered bonds was reported. FY21 observed an issuance of Rs. 2,220 Crore worth of covered bonds by Indian Issuers, which was a significant leap from a meagre Rs. 400 Crore issuance in the previous financial year.[6] A primary reason behind the sudden surge in issuance of covered bond is that when compared to unsecured bank bonds, the covered bonds offer the investors a safer banking debt instrument by incorporating an additional layer of collateral. [7] Despite the sudden growth, the legislation and market-awareness surrounding covered bonds has a long path paved ahead of itself to find success.

The author, through this research paper aims to provide a coherent understanding of the covered bond market in India by analyzing the impact of covered bonds in India and analyzing the trend of covered bond issuance. The paper in this section also highlights the role of covered bonds in strengthening the fixed income market of India. The paper, in the second section, analyzes the introduction of Structured Notes ('**ESN**') in the European framework following the concept of covered bonds. The paper in this section also attempts to draw a comparative analysis of the framework adopted by the European Union and India. The paper then concludes by suggesting a way forward for the Indian bond market.

II. Strengthening the Indian financial market: Analysing the impact of Covered Bonds

Benefits and Security of Covered Bonds as an Attractive Investment Option in India

The Indian financial market has observed that the non-bank lenders have faced tremendous issues with liquidity in the recent past.[8] The collapse of asset quality and Infrastructure Leasing and Financial Service ('**IL&FS**') can be traced to be one of the main reasons behind this illiquidity.[9] Consequently, there arose a need for the lenders to revive their liquidity and make an attempt to borrow securities at lower rates. Amidst those needs, covered bonds acted as redemption for such lenders. The trajectory of covered bonds has been such that it is seeing a wide acceptance and enthusiasm from long-term institutional investors.[10] The primary reason behind this is the low-risk and high reward nature of covered bonds and the dual recourse available to the investors.[11] Covered Bonds provide bankruptcy-

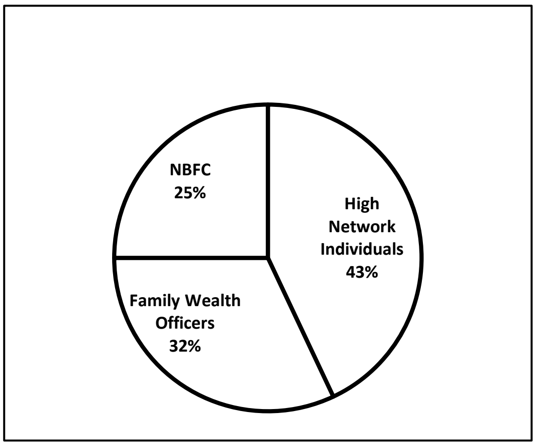
[4] Chailloux, Alexandre, Simon Gray, and Rebecca McCaughrin. *Central bank collateral frameworks: Principles and policies*. Washington, DC: International Monetary Fund, 2008.
[5] ICRA Limited. "Emergence of covered bonds as an alternate fund-raising avenue; volumes expected to pick up with better stakeholder awareness." ICRA Press Release, 24 June. 2021
[6] *Id*
[7] Bhanot, K., & Larsson, C. F. (2018). Uncovering the impact of regulatory uncertainty on credit spreads: A study of the US covered bond experience. *Journal of Financial Markets*, *39*, 84-110.
[8] Maurya, A. K. Regulatory Developments and Its impact on Securitisation Market in India. *SAMIKSHA*, 1.
[9] Attarwala, A. A., & Balasubramaniam, C. S. (2020). The rise and fall of non-banking financial companies in India and emerging challenges. In *International Conference on Technology and Business Management* (Vol. 12, p. 14).
[10] Ananth, S., & Öncü, T. S. (2013). Challenges to financial inclusion in India: The case of Andhra Pradesh. Economic and Political Weekly, 77-83.
[11] Vucetich, A., & Watson, A. (2013). Discovering covered bonds–the market, the challenges, and the Reserve Bank's response. *Reserve Bank of New Zealand Bulletin*, *8*(2), 17.

remoteness against the assets of the issuer. Therefore, covered bonds stipulate a dual recourse for the investors: *firstly*, against the collateral pools; and *secondly*, against the issuer.

Furthermore, in covered bond transactions, it is a common practice for the issuer's balance sheet to retain the cover-pool assets for accounting purposes; the assets are typically "ring-fenced,"[12] which entails that they are separated and safeguarded from the issuer's other assets. This separation aims to protect covered bond investors in the unfortunate event of issuer's bankruptcy, ensuring that the cover-pool assets are exclusively available to fulfil the covered bond obligations.[13] This arrangement offers an additional layer of security to the investors and contributes to the attractiveness of covered bonds as a reliable investment option.

Emerging trends for covered bond market in India

It is important to note that the Indian covered bond, though derived from that of Europe, has proved to be different from the system developed in other countries.[14] Contrary to the common practice of backing covered bonds by a residential mortgage, as seen in other countries, India relies more on non-mortgage, vehicular and gold loans for acting as receivables.[15] It can also be observed that traditionally, long-term investors such as insurance companies and pension funds are the sought-after investor class.[16] However, in India due to the gap that exists in investor and stakeholder awareness, it can be observed that the only investor classes that have invested in covered bonds are: High Net-worth Individuals (‘**HNI**’) constituting 43% share, Family Wealth Officers constituting 32% share and NBFC constituting 25% share in covered bond subscriptions.[17]



However, the growth of the covered bond market in FY21 was driven largely due to the increased acceptance of these instruments among Indian investors. This growth was noteworthy primarily because of the uncertainty caused by Covid-19 pandemic; positively, the pandemic did not have a negative impact on the investor sentiment rather made investors cautious about investing in financial instruments that carried higher risk, consequently, this made covered bond a popular choice for risk-averse investors seeking relatively safer investment options.

Particularly, 12 NBFCs have been instrumental in issuing covered bond in the Indian market with 75%[18] of the issuance being done by institutions having ‘A’ credit rating[19]. The majority of such issuance were in the form of Market Linked Debentures (‘**MLD**’) forming approximately two-third of the Indian covered bond market.[20] The ‘A’ rating provides an additional degree of safety when compared to ‘BBB’ rating or ‘BB’ rating. Therefore, covered bonds issued by entities with earmarked cover pools and

[12] Schwarcz, S. L. (2013). Ring-fencing. S. Cal. L. Rev., 87, 69.
[13] Larsson, C. F. (2013). What did Frederick the great know about financial engineering? A survey of recent covered bond market developments and research. *The North American Journal of Economics and Finance, 25*, 22-39.
[14] Schwarcz, S. L. *Supra* note 3, at 2
[15] ICRA Limited. *Supra* note 5, at 2
[16] Ghosh, A. (2022, March 1). Covered Bonds: the story of an Indianized version of a global instrument . Vinod Kothari Consultants.
[17] Saxena, R. (2021, June 30). Covered Bonds: A Liquidity Fix for NBFCs Amid the Pandemic. BQ Prime.
[18] ICRA Limited. *Supra* note 5, at 2
[19] A credit rating is a quantified assessment of the creditworthiness of a borrower in general terms or with respect to a financial obligation.
[20] Livemint. (2021, June 24). Issuance of covered bonds spikes 5 times to ₹2,200 crore in FY21 | Mint.

adequate credit enhancements are viewed as relatively safe investments, which is reflected in their higher credit ratings of 'AA' or 'AAA'.

Ess Kay Fincorp Ltd., recently in 2021, raised Rs. 324 Crore through MLD and Covered Non-convertible Debentures ('**NCD**').[21] The Rating Rationale issued by CRISIL confirmed the bankruptcy remoteness of the assigned car loan receivable from the issuer, however, it underlined that there is no supportive legislative or regulatory framework that supports covered bonds, neither there exists any judicial precedent on the matter.[22]

Legislative Covered Bonds v. Structured Covered Bonds in the Indian framework

Securitization transactions are fairly similar to covered bonds, with the paramount similarity being 'bankruptcy remoteness'. However, securitization transactions involve the originator ('company originating the receivables') transferring those receivables to a Special Purpose Vehicle ('**SPV**') in a "true sale" as per the bankruptcy laws, hence, achieving bankruptcy-remoteness.[23] Contrastingly, covered bonds achieve bankruptcy-remoteness through the method of ring-fencing.

Two primary benefits can be construed from the legislative covered bond system: *firstly*, statutory framework guarantees certainty to the investors regarding their rights and responsibilities in case of insolvency or bankruptcy of the issuers; and *secondly*, proper statutory framework can ensure that the cost for structing a covered bond transaction can be lowered.[24] However, with a statutory and legislative framework, the covered bond regime becomes rigid in the sense that it limits the type of collaterals to high quality assets such as mortgage loans, public sector debts etc. that serve as the cover pool. As a result, covered bonds can be only as protective as the legislation allows.[25]

The National Housing Bank and the SEBI made attempts to introduce structured statutory framework for covered bonds in India[26]. Despite the involvement of several multilateral bodies and discussions on covered bonds, the market did not wait for regulatory intervention. In India, since there exists no statutory framework, the benefits of a structured covered bond can be enforced through contract and insolvency and bankruptcy laws. Hence, the concept of bankruptcy-remoteness is achieved through product engineering that involves a legal sale of the cover pool to a distinct trust, while still allowing the issuer to maintain economic control until certain predetermined trigger events occur[27].

In such cases, transaction costs are higher since such product-engineering for ring-fencing requires complex transaction structures.[28] However, such secured covered bonds have flexibility as they can be tailored as per the terms of the contract to suit market conditions, to meet higher level of overcollateralization, to ensure asset quality or to enhance substitutability.[29]

Additionally, legislative covered bonds provide greater legal certainty and are given preferential treatment in the event of insolvency. Structured covered bonds may also be perceived as less secure by

[21] ICRA Limited. "Ess Kay Fincorp Limited: Rating confirmed as final for non-convertible debentures". ICRA Press Release, March 18. 2021.
[22] CRISIL, An S&P Global Company. "Rating Rationale- Ess Kay Fincorp Limited". Mumbai. June 30. 2020.
[23] Gorton, G. B., & Souleles, N. S. (2007). Special purpose vehicles and securitization. In The risks of financial institutions (pp. 549-602). University of Chicago Press.
[24] Stengel, S. A. (2011). The legislative framework for US covered bonds: facts and myths. Journal of Structured Finance, 17(2), 81.
[25] *Id*
[26] National Housing Bank- Report and Recommendation. Working Group for promoting RMBS and other alternative Capital Market Instruments - Covered Bonds.
[27] Larsson, C. F. *Supra* note 13, at 4
[28] Schwarcz, S. L. *Supra* note 3, at 2
[29] Id

investors, as they lack the specific legal framework provided by legislative covered bonds.[30] However, the process of enacting specific legislation can be time-consuming and requires political intervention.[31] Structured covered bonds, on the other hand, are quicker to implement and require less political intervention. Thus, making it a more suitable choice for India because of the reason that covered bonds are an emerging trend and are not thoroughly developed or even accepted.

III. Exploring the potential of European Secured Notes: Lessons from the European market

European Secured Notes ('**ESN**') have acted as a safeguard for the European Union amidst the Covid-19 pandemic as an efficient tool for economic recovery.[32] The primary aim of ESN is two-fold: first, to mobilize capital; and second, to provide businesses with greater funding at lower costs. ESN's can be construed as a dual recourse instrument, similar to covered bonds, that supports lending to infrastructure projects and Small and Medium Enterprise's ('**SME**').[33] Although ESNs would be a novel form of debt issuance, the underlying concept is not entirely new.

In 2013, Commerzbank issued a dual-recourse instrument that was secured by SME loans.[34] These bonds were unregulated and issued purely on a contractual basis. Although well-received by the market, no similar deals were executed. In 2014, the Banque de France endorsed the establishment of the European Secured Notes Issuer ('**ESNI**')[35], a special-purpose vehicle that issued notes backed by collateralized credit claims, resembling a securitization transaction.

Direct access of SMEs to Capital Market for Credit Funding

Asset-backed securities involve an off-balance sheet securitization technique where the underlying asset is transferred to a special purpose vehicle (SPV).[36] Comparatively, covered bonds are debt securities that are guaranteed by specific cover assets held in a segregated cover pool. ESNs, on the other hand, are a collateralized bond that differ from traditional covered bonds in two aspects: *firstly*, in terms of the collateral backing the notes; and *secondly*, in terms of the purpose of funding assets such as SME loans instead of mortgage and public-sector loans.[37]

SMEs are critical to the overall European economy, as they comprise of majority of businesses in the EU, employ 93 million people, and generate EUR 4 trillion in added value. Although SMEs receive between 75% to 80% of their funding from the banking system[38], they face difficulties in securing financing. Since SMEs have limited access to funding through the capital market, bank loans are one of their most crucial external sources of funds. However, these loans are considered riskier for banks,

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[30] *Id*
[31] Saxena, R. *Supra* Note 17, at 5
[32] Fletzberger, B., & Kern, M. A. (2019). Covered bonds and European Secured Notes - status quo and next steps. Lexology.
[33] Dieric, B. (2018). European Secured Notes as a new asset class. European Covered Bond Fact Book. ECBC Publications, 13th ed., Brussels, 117-122.
[34] Nassr, I. K., & Wehinger, G. (2014). Non-bank debt financing for SMEs: The role of securitisation, private placements and bonds. OECD Journal: Financial Market Trends, 2014(1), 139-162.
[35] *Id*
[36] Ayotte, K., & Gaon, S. (2011). Asset-backed securities: costs and benefits of "bankruptcy remoteness". The Review of Financial Studies, 24(4), 1299-1335.
[37] Tuškan, B., & Stojanovic, A. (2019, June). Innovative structures of covered bonds: perspective in financing small-and medium-sized enterprises. In Proceedings of FEB Zagreb International Odyssey Conference on Economics and Business (Vol. 1, No. 1, pp. 519-530). University of Zagreb, Faculty of Economics and Business.
[38] *Id*

given the higher credit risk associated with SMEs, and thus, the business policies adopted by the bank are more rigid, making it challenging for SMEs to access funding through this route. [39]

Urgency of ESN: A Global Perspective from Europe to India

The European Banking Authority (EBA) suggested that ESNs should be structured as dual-recourse instruments, allowing investors to have both a priority claim over the loan portfolio used as collateral to secure the ESN, and a direct claim against the issuing or guaranteeing bank.[40] As a result, SME loans represent a riskier component of a bank's credit portfolio and are more challenging to incorporate into structured finance models that require standardization of the cover pool. The primary reason why SME loans are not frequently used for the issuance of covered bonds is their non-standardization and the high level of risk associated with them.[41]

While securitization structures allow for the transfer of risk to investors, SME loans are still not commonly used in these models. However, the importance of SMEs in the economy highlights the need for more advanced financing techniques and models to be developed based on SME loan portfolios.[42] The proposal of SME ESN is a welcome development, but regulatory treatment and government interest will be important for wider acceptance and usage of this financing technique.

Similarly, in the Indian context, SMEs have contributed a total of 36% to the manufacturing output of India.[43] It is also expected that by 2024, SMEs shall contribute over 2 trillion dollars and shall additionally create 50 million jobs.[44] India is also considered as one of the largest SME markets of the world. The need for increased liquidity for SMEs has always been important, but the Covid-19 crisis has amplified this need. As a result, the issuance of SME-loan-backed covered bonds, such as ESNs, becomes a need of the hour to promote economic growth and entrepreneurship.

IV. Conclusion

Around 250 years ago, the Pfandbrief system was established, which introduced covered bonds as a significant means of market-based funding for European countries to develop a productive and efficient capital market. While covered bonds were initially used to refinance public sector debts in Europe, they are now being embraced by various nations to enhance their capital market framework. India has seen a surge in covered bond issuance owing to the increased financial awareness after the Covid-19 pandemic recognizing the need to develop a transaction structure that yields higher rewards for lower risks.

The author through this article has attempted to provide a coherent understanding of covered bonds in India by highlighting the benefits accrued by the issuance of covered bonds in the Indian bond market.

[39] Kothari V., & Ghosh A. (2021, August 19). Use of dual recourse instruments for SME finance: The Making of European Secured Notes.
[40] Dieric, B. *Supra* note 33, at 8
[41] Tuškan, B., & Stojanovic, A. *Supra* note 37, at 8
[42] Beaumont, J. (2019). Covered bond harmonisation: a milestone reached. European Covered Bond Council, 22.
[43] Das, G. (2022, December 14). India's SME segment is going to be a driving force for India's output, but tech penetration remains low to. The Economic Times.
[44] *Id*

It can be observed that Indian investors have gained a new-found interest in covered bonds primarily because: *first*, it provides bankruptcy remoteness against the issuer; *second*, it provides a dual recourse in cases of insolvency or bankruptcy of the issuer; and *third*, the assets remain on the balance sheet of the issuer to retain cover-pool and are ring-fenced.

The author highlights the difference that exists between the Indian covered bond market from that of other countries. Despite the COVID-19 pandemic, the covered bond market in India grew due to increased acceptance among investors seeking relatively safer investment options. Several examples are drawn throughout the paper to provide a backing for the emerging positive-trend in the Indian bond market.

However, a constant debate surrounding the non-existence of a proper statutory framework has raised several questions in the mind of the investors regarding the reliability of such issued covered bonds. The author attempts to answer this conundrum by enumerating that since India is still developing market-awareness regarding the issuance of covered bonds, it is a better step to rely on contract and bankruptcy laws for the enforceability of such bonds. This shall ensure that: *first*, there is a minimal legislative interference which is not time-consuming; and *second*, it shall provide a greater flexibility to tailor the covered bonds as per the existing and everchanging market conditions in India.

The author, in the next section, enumerates that the urgency of ESN not only exists in Europe but also in India, especially owing to the financial market conditions after the Covid-19 pandemic. SMEs in both regions require increased liquidity, and the issuance of SME-loan-backed covered bonds becomes a need of the hour to promote economic growth and entrepreneurship. The author believes that since a large part of the Indian economy is dependent on SMEs, it becomes important to adopt a similar structure to that of Europe and other countries. ESNs have a very similar nature to that of covered bonds, however, the focus of non-bank lenders on infrastructure projects and SMEs shall ensure that there is an increased stakeholder-awareness at all levels, which remains the first step for success of covered bonds in the Indian bond market.

Legality of credit risk transfer arrangements in India in light of the prohibition on synthetic securitisation under Securitisation Directions

Legality of credit risk transfer arrangements in India in light of the prohibition of synthetic securitisation under SSA Directions

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Credit risk transfer arrangements could have very broad connotations. The objective of such credit risk transfer could be to maximise profits by way of leverage, credit inter-mediation and development of secondary market for loans. One of the realisations in aftermath of run up to global financial crisis 2007-2008 (GFC), was that undercapitalised financial institutions taking excessive leverage, was the perfect recipe for financial disaster. Post GFC, the regulatory focus has shifted to de-leveraging the financial institutions by way of building up more regulatory capital requirement, liquidity requirements, counter-cyclical buffers for banks and financial institutions. Therefore, there is tradeoff between financial institutions searching for maximizing their return on the capital and the regulators ensuring that financial stability of the system.

Indian context is no different from global scenario, however, RBI has been treading very cautiously specially when it comes to opening up of debt market for investments in complex structured financial products, such as non-funded loan participation and synthetic financial products. This article in the first part explains the reasons for fragility in the financial system and logic for macro prudential regulations. In the second part, permissible modes of credit risk transfer in respect of contrast between transfer of credit risk and sharing of credit risk has been covered. The third part discusses the securitisation structures as the tool to transfer credit risk, with difference between the traditional funded securitisation and synthetic securitisation structures in light of prohibition on synthetic securitisation under Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021 (SSA Directions). The last part concludes with the way forward for developing deeper markets while continuing to transfer credit risk.

I. Fragility in the financial system

Banks perform credit intermediation and maturity transformation by converting on-demand retail deposits on the liabilities side of its balance sheet into long term loans forming part of the asset side of its balance sheet. Similar to banks, other financial institutions such as non-banking financial companies also perform credit intermediation and maturity transformation. They convert capital market borrowings or banks borrowings that form part of the liability side of the balance sheet into long term loans which form part of the assets side of the balance sheet. While, generally the nature of the liabilities between banks and non-banking financial companies are very different, retail customers' deposits with banks are idiosyncratic, but there is always a risk of 'bank run' in times of stress. Similarly, non-banking financial institutions in stressful times may encounter the risk of freeze up on their future funding or run on their debt capital market instruments, infamously also referred to as run on wholesale funding markets[1].

[1] John Armour, Dan Awery et.al. 'Principles of Financial Regulation' Oxford University Press 2016

Evidence from the past suggests that even financial intermediaries like mutual funds could dry up due to high withdrawals[2]. Therefore, in addition to regulatory capital requirements, there is always a requirement to perform liquidity matching function of the cashflows by financial institutions. Though from the general sense it appears that capital risk give rise to bankruptcy risk, however, in the case of financial institutions very often it has been seen that the maturity mis-match/ liquidity risk gives rise to bankruptcy risk[3]. One of the prime reasons is usually run of retail deposits of the banks and whole-sale funding market freeze for non-banking financial institutions. Though banks have recourse of approaching lender of last resort (RBI), nevertheless, bank runs and fire sale in wholesale funding markets can exacerbate the liquidity risk into bankruptcy risk, which makes investors the sector agnostic and there is risk of contagion on securities of other stable financial institutions[4]. Consequently, financial institutions are very fragile and inter-connected to one another systemically. The micro-prudential response of the regulators to preserve the stability of the individual financial instructions is by way of implementation of regulatory capital requirements on the assets based on the risk weights as prescribed under BASEL III norms and stable liquidity conditions by bucketing of cashflows and investments in high quality liquid assets (HQLAs) through liquidity risk management framework[5]. These macro prudential norms in turn reduces the return on capital for the financial institutions, therefore, there is always search for credit risk transfer modes for optimization of capital along with source of funds to fund new loans.

II. Credit Risk Transfer Arrangements

Credit risk is not defined under Indian law; however, most simplified definition of credit risk would be where a counterparty will fail to meet its obligations in accordance with agreed terms. Therefore, credit risk is transfer of risk on default in true sense. Financial institutions aim to maximize their risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters.[6]

Is it transfer of risk or sharing of risk?

In the simplest form of arrangements, a transaction as simple as transfer of a loan exposure involves transfer of credit risk. In India, transfer of loan exposures is governed by Master Direction - Reserve Bank of India (Transfer of Loan Exposures) Directions 2021 ("TLE Directions"). The transfer of loan involves a seller (typically an originator or the principal lender of the loan) transferring complete or partial economic rights in an underlying loan to a buyer (transferee of the loan) of such economic rights. TLE Directions cover loan transfers that can be undertaken between the financial institutions in India,

[2] Rituraj, M Jagadeesh, Abhishek Kumar and Amit Meena, 'Market Financing Conditions for NBFCs: Issues and Policy Options', (RBI Bulletin June 2020) available at
< https://www.ccilindia.com/Documents/Rakshitra/2020/July/Article%20Summary.pdf>
[3] European Central Bank, 'Lenders on the storm of wholesale funding shocks: Saved by the central bank', available at < https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1884.en.pdf>
[4] Rituraj, [Fn 2]
[5] Generally see Master Circular – Basel III Capital Regulations, available at https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=12278>; Liquidity Risk Management Framework for Non-Banking Financial Companies and Core Investment Companies available at <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11719>
[6] Basel Committee on Banking Supervision, Basel III Document Revisions to the securitisation framework, dated 11 December 2014 (rev. July 2016)

and only permits loan transfers *interse* the 'lenders' (as defined in the TLE Directions)[7]. The TLE Directions covers loan transfers by way of sale of loans through novation or assignment, and loan participation. The TLE Directions stipulates that in case of transfer of loans by way of assignment or novation, legal ownership of the loan shall be mandatorily transferred to the transferee(s) to the extent economic interest transferred.

The loan in its most generic sense is an asset in the books of the financial institution, i.e., receivables of cashflows over a period of time. Transfer of loan by way of novation is basically the case, whereby the underlying obligor is also made party to the transfer arrangement. There is legal certainty on transfer of receivables along with ownership thorough novation, but there is no flexibility, as engaging the underlying obligor might not be the efficient way for achieving transfer of credit risk.

While 'assignment' of receivables has picked up as a global legal tool for transfer of loan exposure along with underlying credit risk, due to its extensive usage. Assignment of receivables in its regular view is the transfer of one's right to receive money in favour of other, without being party to the original agreement.[8] TLE Directions mandate that legal ownership should be transferred to the extent economic interest transferred. Therefore, it is important to structure the transfer of receivables as true sale, such that transfer is respected in bankruptcy or similar situations. The assignment transactions run a risk of re-characterization if not structured as true sale[9]. Though the word 'true sale' does not appear under the TLE Directions, as a nomenclature has been done away with under the TLE Directions, nevertheless, transfer of legal ownership is a more ringfenced approach to achieve bankruptcy remoteness in assignment transactions.

Insolvency and Bankruptcy Code 2016 ("IBC"), covers "debt that has been legally assigned or transferred to" under the definition of 'financial creditor'[10]. There is not much legal jurisprudence on the rights of the transferee that has received loan receivables by way of assignment. However, reference could be drawn from Bombay High Court order 13 November 2019 in *Reliance Nippon Life Asset Management Limited Vs. Dewan Housing Finance Corporation Limited and ors*[11], whereby rights of the beneficiary of the receivables under assignment agreement were protected by the court. Subsequently, Ministry of Corporate Affairs (MCA) by its notification dated 30 January 2020, issued a notification in pursuance of rule 10 of the Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules, 2019, regarding '*assets of third parties*' and guiding administrators on insolvency commencement date to: (i) prepare a statement of third party assets and the respective contracts; (ii) ensure that such assets are maintained in a separate and distinct manner, capable of identifying them contract-wise, and are not merged with those of financial service provider; and (iii) return or transfer such assets to the person entitled to receive it in accordance with the terms and conditions of such contract. As per the Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules, 2019, section 14 of IBC is not applicable to third party assets or properties.

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[7] clause 5 of the TLE Directions provide as follows: "*These directions will be applicable to all loan transfers undertaken by the lenders as mentioned in Clause 3, including sale of loans through novation or assignment, and loan participation. Provided that in cases of loan transfers other than loan participation, legal ownership of the loan shall be mandatorily transferred to the transferee(s) to the extent of economic interest transferred.*"

[8] Please refer to section 130 of Transfer of Property Act unless waived centrally by the debtor. Further please refer to Vinod Kothari, 'Law of Assignment of Receivables', available at <https://vinodkothari.com/wp-content/uploads/2013/12/Law-of-Assignment-of-Receivables-Vinod-Kothari.pdf>

[9] The erstwhile securitisation and direct assignment directions emphasised on 'true sale' structure while transfer of receivables by way assignment under the erstwhile regimes.

[10] For further discussion on assigned assets and insolvency/liquidation estate, bankruptcy remoteness, true sale, refer to Vinod Kothari Consultants, "*Securitisation & Transfer of Loan Exposures- A comprehensive guide*", Chapter 4, pp. 59-85.

[11] *Reliance Nippon Life Asset Management Limited Vs. Dewan Housing Finance Corporation Limited and ors,* Bombay High Court order dated 13 November 2019, available at < https://indiankanoon.org/doc/28385535/>

Loan participation is a transaction through which the transferor (grantor), which is the originator of a loan, transfers all or part of its economic interest in a loan exposure to a transferee (participant), without the actual transfer of the underlying loan contract. The essence of the loan participation is that there is transfer of credit risk in the underlying loan, by way of transfer of economic interest, but there is no transfer of the legal ownership in the loan. The loan remains in the books of the originator, i.e., originator remains the lender on record.

It is to be noted that in all the above mode of credit risk transfer there is transfer of risk and reward and there is no buildup of leverage in financial system, since credit enhancement of any sort is not permitted for loans transferred pursuant to TLE Directions. While credit risk is only transferred to the extent of economic interest transferred. In cases where complete economic interest is transferred the underlying loan goes off-balance sheet i.e., no credit risk is held with transferor. Nevertheless, the credit risk transfer would ideally be a situation where the originator gets to keep the maximum reward with complete transfer of the default risk. Therefore, it wouldn't be wrong in arguing that transfer of loan exposures under TLE Directions is not a risk transfer instrument but merely a risk sharing mechanism, which is no different from a typical loan syndication transaction or a co-lending transaction, where the credit risk is shared with the transferee on back-to back basis.

Is it risk sharing or risk transfer?

Globally, loan participation structures are of two types funded participation and non-funded participation[12]. Whereby in the former the participant funds the grantor upfront to the extent of economic interest participated, however, in latter the participant fund the grantor upon occurrence of the default trigger event of the underlying loan. It is pertinent to note that TLE Directions permits only funded loan participation arrangements. The funded-participation involves immediate transfer of risk and rewards without any credit enhancement. However, in non-funded participation there is transfer of credit risk in true sense, as the grantor only transfers the credit risk (default risk) to the participant while the benefits/rewards from the underlying loan is retained by the grantor. In Indian context non-funded participation are not permitted as the TLE Directions require the transferee (participant) to provide funds to the transferor (grantor) to the extent economic interest transferred. Further, all loan transfers under TLE Directions should have immediate separation of the transferor's risks and rewards associated with loans to the extent that the economic interest transferred in favour of transferee[13]. Non-funded participation appears to be credit risk transfer instrument in true sense; however, it is not available as credit risk transfer instrument for the lenders in Indian context.

III. Securitisation as mode of credit risk transfer

Securitisation involves transfer of underlying loan pools to a special purpose vehicle (SPV) by way of assignment. The receivables in the pool are prioritised/ structured in such a manner that it leads to multiple tranches. The equity tranche, i.e., first loss piece to the structure is retained by the originator and mezzanine and senior tranches are sold to investors by way issue of securitisation notes by the SPV. Each tranche under the securitisation structure bears different risks and returns, catering to the needs of the investors with differential risk and returns appetite. The investors upfront funds to the SPV to the extent of investment exposure in securitisation notes which in turn are used by SPV as consideration

[12] IIFM Standard 11 MPA Standards by the International Islamic Financial Market ("IIFM") in collaboration with the Bankers Association for Finance and Trade ("BAFT") for Islamic trade finance related participation arrangements; available at<https://www.iifm.net/public/standards/published-standards/trade-finance-standards/iifm-baft-master-unfunded-participation-agreement>

[13] Para 15, TLE Directions

for purchase of loans from the originator. The SPV acts as a pass-through structure, and all receivables from the underlying obligors in the pool are passed to investors in order of seniority of the securitisation notes.

Does securitisation provide credit risk transfer?

Securitisation is a great credit intermediation tool, since credit rating of its each rated tranche and the probability of default of the underlying loan pool, is independent of credit rating of the originator. It gives the originator the chance to achieve a cheaper source of funding by transferring its underlying loans to the SPV and issuing high rated securitisation notes (having better rating than that of the originator) through implicit or explicit support to the securitisation structure.

This implicit or explicit support structure is referred to as credit enhancement. It is to be noted the first loss support piece (equity tranche) along with the excess interest spread in the securitisation structure is held by originator, therefore it sweeps the highest return, while the senior investors in securities notes receives comparatively lower yield, as they are holding less risky tranche with notched up credit rating due to protection from originator's equity tranche.

The transfer of underlying pool to the SPV is bankruptcy remote, i.e., there is transfer of legal ownership in the underlying pool (i.e., true sale), similar to the transfer of loans by way of assignment under TLE Directions. However, unlike assignment transactions under TLE Directions where there is immediate separation of risk and rewards, securitisation transactions do not lead to complete transfer of risk and rewards due to credit enhancement provided to the structure. This credit enhancement is usually by way of retention of equity tranche by the originator, cash collaterals or subordination of excess interest spread by the originator. Securitisation is a good tool to raise funds, but it is not ideal for capital relief for the originator. While the transaction may be structured as true sale equivalent under the SSA Directions. However, capital relief is subject to de-recognition of securitisation pool under IND AS 109. Nevertheless, there are additional regulatory capital relief for investors for securitisation structures under SSA Directions meeting the simple, transparent, and comparable (STC) securitisation criteria as prescribed under the framework. It would be hard to conclude that securitisation leads to transfer of credit risk form the originator, since the originator is first in line to bear the risk of default by the underlying borrowers, to the extent it could lead to there is no transfer complete wipe out of equity tranche.

CDS and Synthetic securitisation- Credit risk transfer

An alternate mode of achieving transfer of credit risk in contrast to securitisation is by way of synthetic securitisation, whereby the credit risk of the underlying pool is transferred by way use of derivatives or guarantees, and the exposures being securitized remain exposures of the originator institution. The SSA Directions defines the securitisation as follows:

> *"synthetic securitisation" means a structure where credit risk of an underlying pool of exposures is transferred, in whole or in part, through the use of credit derivatives or credit guarantees that serve to hedge the credit risk of the portfolio which remains on the balance sheet of the lender;*
>
> *Explanation: The above definition does not include the use of instruments permitted to lenders for hedging under the current regulatory instructions*"

In order words synthetic securitization transfers the credit risk of underlying pool without transferring the ownership of such pool. The transfer of credit risk takes place through a credit protection agreement, whereby the protection seller agrees to indemnify the losses of the originator (protection buyer) upon occurrence of trigger event (credit event) in respect to reference obligation.

The reference obligation is the mezzanine and senior tranches, for which the originator buys the protection, while the protection seller is better off as they get support of the equity tranche and payment of premium from synthetic holding (by way of guarantee) on highly rated securitised tranches. Further the probability of default in senior tranches are very low, almost negligible, additionally, it also allows protection sellers to have indirect exposure to diversified pool of the underlying obligors of a particular class in exchange of premium.

Since the originator receives a guarantee in respect to reference obligation (mezzanine or senior tranche) from protection seller, technically, except in case of occurrence of the default event (credit event), there is no flow of funds from protection seller to the investor during the life of the synthetic securitisation pool. The originator is better off since it continues to receive receivables from the underlying pool, while the originator is still being lender on record. Further receiving of guarantee on mezzanine tranche and other senior tranches, the originator's credit risk in respect to such reference obligation is replaced by the credit risk of the guarantor, which is usually a highly credible bank or financial institution. Therefore, synthetic securitisation allows originator to retain substantial rewards from the synthetic securitisation structure, while freeing up its regulatory capital, and maintaining better risk weighted return on its capital.

Criticism to Synthetic Securitisation & CDS

The SSA Directions unequivocally prohibits lenders from undertaking synthetic securitisation. Synthetic securitisation structures where heavily criticized as they were instrumental in the run up to the GFC. Synthetic securitisation lead to the moral hazard problem. The protection seller took high leverage on the mortgaged backed synthetic securitisation pools, since it did not involve any out flow of funds from the protection sellers, while the reference obligation were high rated debt instruments, which were presumed to have negligible risk of default. On the contrary protection buyers (transferors) generated sub-prime loans as the underlying credit risk were transferred to protection sellers through synthetic securitisation.[14] There was substantial leverage and counter-party risk buildup in the financial system due to heavy selling of credit default swaps (CDS) in the market.

There has been recent resurgence of synthetic securitisation in the market, with arguments contrary to traditional securitisation, citing that protection seller under synthetic securitisation is better placed to assess credit risk in the underlying pools of the synthetic structure[15]. There are arguments for development of framework for simple, transparent, and comparable securitisation framework for synthetic securitisation transactions.[16] Globally, especially in Europe the synthetic securitisation structures are on rise as there are incentive to undertake such transactions,[17] for attaining capital relief.

SSA Directions only permits traditional cash funded securitisation where the originator gets funded upfront, unlike non-funded synthetic securitization where investor (protection seller) simply receives payment of premium for the credit risk assumed by the investor. Needless to say that synthetic securitisation structures are much more leveraged investments form investors side than the traditional funded securitisation. As protection seller tends to make riskless profits, however, in times of stress or materialisation of the credit event, it could wipe out the entire capital of highly leveraged protection

[14] BCBS, 'Report on asset securitisation incentives', available at < https://www.bis.org/publ/joint26.pdf>
[15] Nicolas M. Dillavou, 'The Regulatory Trajectory of Synthetic Securitization: A Breakdown of International Regulatory Environments', available at < https://digital.sandiego.edu/cgi/viewcontent.cgi?article=1299&context=ilj>
[16] Ibid.
[17] Vinod Kothari, 'Resurgence of synthetic securitisations: Capital-relief driven transactions scale new peaks', available at < https://vinodkothari.com/2022/03/resurgence-of-synthetic-securitisations/>

seller, thereby risking the financial stability of the system. Further it could also be argued that to an extent, synthetic securitisation structures are akin to non-funded risk participation arrangements, whereby there is a contract to indemnify the originator of its losses on the pool, upto an extent, in exchange of a risk premium.

The transfer of credit risk where there is a single reference obligation underlying a derivate contract is called credit default swap (CDS), while the portfolio of reference obligations sliced into various tranches of risk is called collateralised debt obligations (CDOs). The CDOs are also not permitted in Indian context, as they are re-securitisation exposures.

There is fine line of difference between synthetic securitisation and a CDS. The Indian regulator has been moving very cautiously with respect to credit risk mitigation market and does not outrightly prohibits financial institutions from entering into CDS contracts[18]. RBI Master Direction – Reserve Bank of India (Credit Derivatives) Directions, 2022 ("CDS Directions"),[19] permits single name CDS contract therefore, there is no bucket/portfolio of CDS and CDS is permitted for single reference obligation. CDS for asset-backed securities/mortgage-backed securities and structured obligations such as credit enhanced/guaranteed bonds, convertible bonds, etc., are also not permitted as reference obligations. RBI BASEL III norms permits credit risk mitigation for CDS positions, provided operational requirements under CDS Directions and chapter 7 of Master Circular on Basel III Capital Regulations.

IV. Conclusion

In Indian context transfer of loan exposures could either be through TLE or SSA Directions. There are very limited credit risk transfer tools, or to be more precise credit risk sharing tool permissible under TLE Directions and SSA Directions. The bankruptcy remoteness of the novation and assignment transactions under TLE and SSA directions have legal certainty in respect to third party assets. However, there is no guiding legal principle in respect to transactions such as funded loan participation where the originator retains title of the underlying pools transferred. Funded loan participation can be structured to have transfer of ownership of the underlying pool in favour of transferee (participant) upon occurrence of contractually agreed enforcement event. In case of non-funded loan participation and synthetic securitisation, credit risk transfer is attainable, however, they are not permitted transactions under the Indian law. There is always a tradeoff between market growth and financial stability. In Indian context, RBI is cautiously dealing with the financial system, owing to the interconnectedness and systemic risk that could emanate from leverage and concentration of credit risk in a particular sector or entity. Credit risk transfer by way of simple CDS is permitted, opening up the routes for non-funded loan participation and synthetic securitisation structures do not seem a near future possibility.

[18] For discussion on RBI cold feet on looking at global CDS market, refer to Vinod Kothari, 'Draft Credit Derivatives directions: Will they start a market stuck for 8 years?', available at < https://vinodkothari.com/2021/02/rbi-issues-draft-directions-on-credit-derivatives/>

[19] Available at < https://rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12226>

About Indian Securitisation Foundation

Indian Securitisation Foundation (ISF) is a not-for-profit organisation incorporated under section 25 of the Companies Act, 1956, a representative body of the securitisation industry in India. ISF is formed with the objective of developing, promoting and protecting the securitisation, structured finance markets in India in particular, and market for fixed income securities in general.

Securitisation in India is not just a fixed income investing instrument, but essential for the idea of financial inclusion, in form of priority sector lending. Banks meet their priority sector targets partly through portfolio acquisitions and securitisation, thereby putting securitisation at par with the banking book.

Infrastructure sector also depends substantially on securitisation for equity extraction.

In essence, the significance of securitisation to India's financial sector cannot be under-estimated.

Over time, credit default swaps are also expected to be prevalent as ways of synthetically replicating credit risk.

It is a clear policy choice to have a strong market for fixed income securities in India: structured finance securities are an essential part of that market, to provide variety, choice and alignment to investor needs.

In this background, ISF was conceptualised to provide direction, leadership, advocacy and support to the securitisation and structured finance industry.

Some of the functions of the Foundation include:

- **Advocacy–** making representation to various authorities from time to time on matters as may concern securitisation and similar capital market instruments.
- **Industry forums and networking -** holding periodic conventions and educational courses.
- **Development of industry standards -** framing self-regulatory standards on disclosures, reporting, servicing reporting, DOs and DONTs for securitisation and direct assignment transactions, etc. Development of standards such as standard assignment agreements, assignment procedures, notification procedures, etc. on the lines of ISDA agreements and encouraging members over period to start using such standard templates.
- **Information exchange –** on matters of common interest, collateral performance, etc

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