Paper 7

Asset Securitisation ©
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A. Introduction

Securitisation of loan assets hit the headlines once again. Citibank, recently sold its car loan portfolio comprising of 1,358 cars to a Special Purpose Vehicle (SPV). Debentures carrying a coupon rate of 15.5 per cent per annum worth around Rs. 20 crore have in turn been issued by the SPV named as -- Peoples Financial Services Limited. These debentures are backed by the car loan portfolio of Citibank. Several institutional investors and mutual funds have picked up these debentures.

The SPV will make monthly payments to debenture holders out of the inflows from the car loan portfolio. The payments to these debenture holders will include both interest and the principal component. At the end of 27 months the debentures will extinguish and by then the SPV would have paid out the entire principal and interest. For added security, Citibank has kept Rs 1.4 crore as cash collateral in an escrow account from which payments will be drawn in case there is any delay or default by the actual borrower of the loan. However, the loans which have been repackaged and transferred to the SPV are considered good. They have been on the bank's books for a minimum period of six months without any default. Steps have been taken to ensure added investor protection *via* rating. Quarterly monitoring of the SPV by Crisil is on the cards to ensure that the quality of the assets are maintained. News reports cite that this issue is likely to be followed by another aggregating to Rs 50 crore.

This example, illustrates the exact framework behind securitisation of assets. In this case, for the first time in the history of securitisation in India, debentures have been listed. They will be traded on the National Stock Exchange.

B. Securitisation defined

Asset-backed securitisation is the pooling of assets which have an income stream and the repackaging of such assets in the form of marketable securities for sale to the investors. The securities are secured by the assets themselves or by the income derived from them.

In a securitisation mechanism, a portfolio of assets acquired by a company (originator) in the ordinary course of its business is sold to a vehicle created specially for the purpose of such a transaction. This SPV acts as the trustee for the investors. The assets which have been pooled and transferred to the SPV become an ` off balance sheet' item for the originator, except in the case of securitisation of lease receivables. The SPV raises funds either from the issue of securities (as in the above illustration of Citibank) or as loans from banks or financial institutions. The loan or security is generally backed by the underlying asset. During the entire tenure of the transaction, the cash flow accruing from the assets securitised (which would constitute hire purchase rentals in Citibank's example) are utilised by the SPV to make periodical payments either to the bank or the investors. The assignment may be with or without recourse to the originator. Though the assets secure the obligations of the SPV, they continue to be managed by the originator. The assets may also be serviced by a third party.

An issue of asset-backed securitisation can be done either by way of an issue of beneficial interest in a trust or an issue of debt instruments by a company. In case of the former, the investors through the purchase of securities obtain ownership of an undivided share in the assets being securitised. As regards issue of debt instruments by a company, the securitised assets support the repayment of principal and payment of interest to investors. The assets also form the underlying security against such investment. This form of securitisation is common in India.

A recent development in Australia's securitisation industry has been to take advantage of the trust structure by structuring the issue of securities as an issue of debt by the trustee of the trust, with recourse to the trustee for satisfaction of the debt. This recourse is however limited to the assets of the trust.

C. Mechanisms of Securitisation

In America and Europe securities debt instruments assume multidimensional variants. Basically however these can be classified into Pass-Through Certificates, Pay-Through Certificates and Stripped Derivative Structures.

Pass-Through Certificates:
Under the mechanism of Pass-Through Certificates, all the cash flows are received by the originator and passed on directly to the investor through an intermediary known as the SPV. The assignment may or may not be with recourse. If the assignment contains a 'with recourse' clause, then the originator can be hauled up by the SPV in case of defaults in the payment of inflows from the underlying assets. In such an eventuality, the originator regains his rights in the receivables. This is the mechanism commonly prevalent in India.

Pay-Through Certificates:
Under the mechanism of Pay-Through Certificates, all cash flows received by the originator are reinvested by the SPV in gilts or other securities (which bear a fixed rate of interest). Proceeds from such investments are utilised by the SPV to make payments to the investors.

Stripped Derivative Structures:
Lastly, under the Stripped Derivative Structure, cash flows accruing to an SPV are broken into two cash streams i.e.: Principal Only (PO) and Interest Only (IO). Stripped derivative securities are then issued against such segregated cash flows. The PO holders are paid out of the sums derived from the principal component, whereas holders of IO securities are paid out of the interest earnings. These securities are volatile as the value of POs goes up in a climate of declining interest rates. On the other hand, where the trend is towards increasing rates of interest, the value of IOs increases as more interest accrues on the underlying securities. Holders of the instruments issued by the SPV can be either PO holder or IO holders. Speculators take a position depending upon their view of interest rate movements.

Securitisation is in a nascent stage in India, and derivative instruments are used only by

a few top-ranking corporate entities, thus this mechanism has not been tested so far.

D. Merits of Securitisation

Securitisation has several commercial advantages which are discussed below:

Better balance sheet management: Removal of risk weighted assets from the originators balance sheet ensures maintenance of capital adequate ratio. In fact, if the originator is a bank, by securitising the outstandings of a particular client the bank can also increase the limits of finance to such party and ensure that it remains within the cap laid down by the apex bank. However, it should be borne in mind that only good quality assets are selected while cherry picking. This interesting term refers to selecting of loans to be pooled together for securitisation.

In the United Kingdom, the Bank of England in its 1989 Loan Transfer and Securitisation Notice (BSD/1989/1 amended later in April 1992 *via* another notification BSD/1992/93) has laid down well defined criteria relating to exclusion of securitised assets from capital adequacy calculations.

This notification requires that the originator must not own any share capital in the issuer nor otherwise control it. The issuer's name must not include the name of the originator nor imply any connection to it. The originator must not bear any recurring expenses of the issuer though it may make a one-off contribution to enhance the creditworthiness of the issuer and may lend on a long-term subordinated basis. Lastly, the originator may not retain an option to repurchase loans except where the loan portfolio has fallen to less than 10 per cent of its maximum value and the option extends only to fully-performing loans. While banks in India also have to adhere to capital adequacy norms, The Reserve Bank of India has not laid down any such criteria.

Liquidity: Selling of a portfolio of assets results in availability of ready cash. In March 1992, *Tata Engineering and Locomotive Company* (TELCO) sold a pool of loans worth Rs 60 crore to Citibank at a discounted price of Rs 50 crore. Interest in this case on a discounted cash flow basis worked out to 19 per cent. If TELCO had borrowed from a financial institution or a bank it would have ended up paying interest of 20.5 per cent. Thus by securitisation of truck-loan receivables in a recessionary market, TELCO earned a spread of around 2 to 3 per cent and got immediate cash.

Raise cheaper funds: Experience in USA and Europe shows that securitisation is a cheaper form of raising finance for the originator than the traditional forms of debt financing. The TELCO example shown above also proves this advantage of securitisation.

Conversion into marketable securities: Assets such as personal loans, residential mortgages, credit card receivables, lease/hire purchase receivables and trade receivables which are not always marketable in their original forms are converted into marketable securities.

Transfer of risks: Transfer of assets to an SPV results in transfer of all associated risks such as default risk, currency risk and interest risk.

Receipt of on going fees during the tenure of the transaction: In most securitisation issues, the originator is appointed by the SPV as a servicer of the assets. Fees earned to manage the portfolio of assets on behalf of the SPV improve return on capital employed.

E. What to securitise?

This is the question uppermost in the minds of any party wishing to securitise its asset portfolio. To ensure success in securitisation, selection of the right type of assets is important. A wide range of assets having reasonably predictable cash flows can be securitised. While, in India securitisation of auto-finance receivables is in vogue, abroad, securitisation has covered real property mortgages, royalties from films, credit card receivables, export financing receivables, a gamut of loans including infrastructure loans and even telephone accounts. The tenure of the securitised paper, varies depending upon the tenure of the underlying asset. The average tenure in case of auto-loans and credit card receivables is between one to three years. Mortgage backed securities issued against housing loans have a longer tenure of three to ten years.

While constructing a portfolio to be sold to the SPV, it is important to select homogenous assets (those which have a similar interest and maturity profile). A sufficient spread of credit risk should also be available. Assets selected need to have statistically predictable cash flows and levels of arrears and defaults. The asset should be capable of generating an adequate income stream to service the end investor. The popularity of the instrument issued by the SPV is ultimately dependent upon the quality of the underlying asset.

Statistics prove that in India, securitisation of car finance receivables are more popular than those of heavy and light commercial vehicles. Commercial vehicle owners are dependent upon income generated by their vehicle for repayments thus recovery is not assured to the same extent as in the case of private vehicles. The system of accepting post date cheques in car financing business is another added advantage of ensuring quality of the loans securitised. Rating given to asset backed securities is another indicator of quality. Rating agencies like CRISIL, CARE, ICRA and the newly set up Duff & Phelps (India) take into cognizance amongst other things, the lending standards of the originator and the track record of installment payments from its pool of loans. The rating would also incorporate the losses incurred on such loans in the past and the collateral security offered by the originator. Rating gives a degree of protection to the investor and helps in marketing the asset based instrument. However rating fees reduce the spread available to the originator. As the securitisation market is yet to develop in India, the most common deals are securitisation of car loans and truck loans.

Once again, to be on the safe side, it is hire-purchase receivables which are pooled and transferred to the SPV. The originator does not generally transfer lease receivables, as the leased assets appear in its own books of accounts under the block of fixed assets as

Assets Given on Lease.

If lease receivables are securitised, the perception amongst tax authorities could be that the leased asset has becomes an off- balance sheet item for the originator and the originator will be denied the relevant depreciation benefits. Thus in these cases, the written assignment contract should clearly state that it is only the receivables which are being transferred and not the asset itself. However this results in a transfer of income without transfer of asset and attracts the provisions of Section 60 of the Income Tax Act, 1961. This issue will be discussed in-depth later when we discuss tax regulations.

Mortgage backed securitisation of immovable property has still not taken off and only a handful of deals have been transacted. Way back in 1993, Madras based Alacrity Housing Limited sold Rs 3.45 crore worth of housing loans from its books to Citibank. This was the first attempt towards securitisation of housing loans. Later in 1994, HDFC according to newspaper reports securitised its housing loan receivables of around Rs 50 crore.

On the other hand, mortgage backed securitisation was introduced in the USA way back in the 1930's. In this mode of securitisation, pools of housing finance loans are sold to an intermediary -- (Three such intermediaries are in existence *viz.* Fannie May, Ginnie May and Freddie Mac). This intermediary then issues debt securities which are serviced by payments of principal and interest against the housing loan. Fannie May was set up by the United States government in 1938. The objective was to deal in federally insured residential mortgage loans made to lower income individuals. Ginnie May was later set up in 1968 as a part of the US Department of Housing and Urban Development. Freddie Mac was established in 1970 to insure securities backed by pools of non-government mortgages. A similar mechanism was planned in India way back in 1993 whereby National Housing Bank (NHB) was to act as the intermediary. However, this plan continues to be on hold and is pending with the Ministry of Law.

F. The Problems and Hurdles

The reasons for lackluster growth are plenty. Stiff stamp duties in most states, the problems of varying stamp duties in different parts of the country, lack of an on-line data base with the potential originators, lack of clarity in tax laws, non existence of guidelines both by RBI (which governs banks and the leasing activities of NBFCs) and SEBI. The investor base is also restricted.

World over mutual funds, insurance companies, pension funds are the main investor base of securities issued by SPV's. However, in India such securities are generally not listed. Insurance companies and pension funds are not allowed to invest in such securities. Caps are even placed by SEBI on the quantum of investments by mutual funds. No mutual fund can invest more than 10 per cent of its corpus in securitised paper by the same issuer. Fortunately, the recent credit policy has removed restrictions earlier placed upon the banking sector for investments in debt securities.

There exists tremendous potential for securitisation of a variety of assets including

receivables against immovables. It is vital however, to understand all the laws which would cover a securitisation transaction. In fact, knowledge of tax implications is also vital because the tax incidence on the originator, the SPV and the ultimate investor should not be much more than what it was prior to the securitisation.

G. Rules and Regulations

THE TRANSFER OF PROPERTY ACT, 1882

To begin with, securitisation of receivables results in a transfer. The assets comprising of receivables which are on the books of the originator are pooled together and transferred to the SPV. Under the Transfer of Property Act, 1882 receivables are an actionable claim.

Section 3, of the Transfer of Property Act, 1882 defines an actionable claim as follows: A claim of any debt other than a debt secured by mortgage of immovable property or by hypothecation or pledge of movable property, or to any beneficial interest in movable property not being in the possession either actual or constructive of the claimant, which the civil courts recognize as affording grounds for relief, whether such debt or beneficial interest be existent, accruing, conditional or contingent.

Section 130, of The Transfer of Property Act, 1882 relates to transfer of actionable claims. As per sub-section (1): The transfer of an actionable claim, whether with or without consideration shall be effected only by execution of an instrument in writing signed by the transferor or his duly authorised agent, shall be complete and effectual upon the execution of such instrument, and thereupon all the rights and remedies of the transferor, whether by way of damages or otherwise shall vest in the transferee, whether such notice of the transfer as hereinafter provided be given or not.

Sub-section (2) of Section 130 adds that: The transferee of an actionable claim may, upon the execution of such instrument of transfer as aforesaid, sue or institute proceedings for the same in his own name without obtaining the transferor's consent to such suit or proceeding and without making him a party thereto.

Section 131 stipulates that: Every notice of transfer of an actionable claim shall be in writing, signed by the transferor or his agent duly authorised in this behalf, or, in case the transferor refuses to sign, by the transferee or his agent, and shall state the name and address of the transferee.

Under the provisions of Section 132, the transferee of an actionable claim shall take it subject to all liabilities and equities to which the transferor was subject to in respect thereof at the date of the transfer.

Thus once the written document is executed, the SPV gets the lawful right to recover the claims from the concerned debtors, in its own name. Only if the assignment is with recourse, can the SPV take the matter to the originator in case of defaults. In India, notice of the assignment to the debtors is not mandatory under the Transfer of Property

Act, 1882. This is apparent on a reading of Section 130 of the Act.

In the United Kingdom a clear distinction exists between a legal assignment and an equitable assignment.

The paramount difference is that an equitable assignment is not subject to the preconditions of a legal assignment for its efficacy and validity. However, it is as effective as a legal assignment in English Law.

Section 136(1) of the English Law of Property Act, 1925 provides: Any absolute assignment by writing under the hand of the assignor (not purporting to be by way of charge only) of any debt or other legal thing in action, of which express notice in writing has been given to a debtor, trustee or other person from whom the assignor would have been entitled to claim such debt or thing in action, is effectual in law (subject to equities having priority over the right of the assignee) to pass and transfer from the date of such notice (a) the legal right to such debt or thing in action (b) all legal and other remedies for the same (c) power to give a good discharge for the same without the concurrence of the assignor.

Before a legal assignment is effective under Section 136(1), it is necessary that the assignment is in writing under the hand of the assignor, the assignment is absolute for the whole of the debt and lastly express notice in writing has been given to the debtor.

Thus under UK laws a legal assignment cannot be used as a mechanism of transfer where a silent assignment of debt is desired or only a part of the debt is required to be assigned.

Back home, banks or finance companies are unwilling to serve a notice on debtors whose outstandings have been securitised. Thus, the mechanism of equitable assignment is adopted. While the law does not make a clear distinction the Supreme Court, in the well known case of Bharat Nidhi Ltd. v/s Takhatmal (1969 AIR 595) has accepted that there can be an equitable mortgage outside the ambit of Section 130 of the Transfer of Properties Act.

In order to avoid practical difficulties at a later date, as the concerned debtors are not served a notice upon securitisation of their outstanding, in the hire purchase/ lease/housing loan agreement itself a clause can be entered into which stipulates that the originator has the right to transfer the receivables at any future point of time. This would preclude any objections from the debtor at a later date.

STAMP DUTIES

As transfer of receivables results in a conveyance, it attracts stamp duties. Stamp duties vary from state to state and with the sole exception of Maharashtra which recognizes securitisation as a separate and distinct financial transaction, stamp duties are very high. In 1994, the government of Maharashtra (circular dated May 11, 1994 -- STP 1094/CR-369/B-M1) reduced the stamp duties applicable on securitisation of loans from 3 per cent

to 0.1 per cent *ad valorem*. The duties on assignment of credit card receivables was simultaneously reduced from 3 per cent to 0.5 per cent. But even if the underlying asset is situated in Maharashtra and the document of assignment is to be executed in another state, varying stamp duties make the issue complex. In other states of India, the duties vary between 3 per cent to 14 per cent. Karnataka has also slashed stamp duties in relation to movables. However, it has not recognized securitisation as a separate and distinct activity. Assignment of immovables underlying the loans attracts higher duties. It may also involve registration with the concerned Registrar of Assurances, if the assignment is not a beneficial assignment.

Several finance companies to avoid payment of stamp duties have resorted to a circuitous route, whereby only the beneficial title to the receivables is transferred.

THE INDIAN CONTRACT ACT, 1872

Novation and sub-participation are the other variants of securitisation which can be adopted by finance companies or banks to transfer their loan assets. In a novation, there is a substitution of creditors by novation of contractual rights and obligations with the consent of all parties including, the debtors. In a sub-participation agreement, a syndicate member enters into a second loan agreement with a buying bank. The buying bank transfers a deposit to the selling bank which is equivalent to the selling banks' participation in the primary loan. The buying bank agrees with the selling bank to maintain the deposit for the entire period of the primary syndicated loan.

The right to repayment of deposit and interest is wholly conditional upon the extent of payment of interest and principal by the borrower to the selling bank. In case of a default the buying bank does not receive payment to the extent of such default. The risk of non-payment is thus transferred from the selling bank to the buying bank as well as the entitlement to such interest and principal.

Tax issues pertaining to securitisation, in any part of the world revolve around three main issues. The tax incidence in the hands of the originator, the tax levy on the SPV and the incidence of withholding taxes in the hands of the investor.

THE INCOME TAX ACT, 1961

In India, the tax laws are hazy and the tax incidence may also vary from situation to situation. In view of the provisions of Section 60 of the Income-tax Act, 1961 it is important to note whether there is a transfer of the asset or mere transfer of receivables. Securitisation of hire purchase receivables involves beneficial transfer of the asset, as it is the receivable itself which constitutes the asset. On the other hand, the assignment agreement in case of securitisation of lease receivables should be carefully worded. Transfer of lease receivables may not lead to the actual transfer of the leased asset which would remain with the originator.

If it is argued that the lease receivables itself constitute an asset and these have been transferred, then the originator can continue to claim depreciation in his books even on

securitisation. However, in such cases the provisions of Section 60 come into play. This section states: All income arising to any person by virtue of a transfer whether revocable or not and whether effected before or after the commencement of this Act, shall where there is no transfer of the assets from which the income arises, be chargeable to income-tax as income of the transferor and shall be included in his total income.

Thus on securitisation of lease rentals, the lease rentals arising therefrom would continue to be taxed in the hands of the originator even if such income is passed on to the SPV for servicing the debt instruments. The tenet involved here would be that of an application of income and not diversion of income before it reaches the originator.

Securitisation of hire purchase receivables, however is another ball game. Here as the only asset in the hands of the originator are the receivables itself, on securitisation the asset is also deemed to be transferred and the provisions of Section 60 cannot be attracted. In such cases, the gains if any on transfer (difference between the consideration received from the SPV and the receivables outstanding in the books of the originator less charges incurred in the securitisation process) will be the business income in the hands of the originator.

The SPV acts merely as the conduit between the originator and the ultimate investor. It receives income flows from the underlying assets and uses the same to service the instruments issued by it. Thus, it does not earn any income nor does it make any profits.

In the Indian context, the concept of a representative assessee should be borne in mind. The SPV, after all acts as the trustee of the investors and the relevant provisions of the Income Tax Act, 1961 dealing with the concept of a representative assessee come into force.

Section 160 of the Income Tax Act, 1961 defines a representative assessee. As per Section 160(1)(iv) for the purpose of the Income Tax Act, representative assessee means in respect of income which a trustee appointed under a trust declared by a duly executed instrument in writing, whether testamentary or otherwise receives or is entitled to receive on behalf of or for the benefit of any person, such trustee or trustees.

As per Section 160(1), every representative assessee is subject to the same duties, responsibilities and liabilities as if the income were the income received by or accruing to him beneficially . The assessment is however made in the capacity of a representative assessee. This section adds that tax can be levied upon and recovered from a representative assessee in a like manner and to the same extent as it would be levied upon and recoverable from the ultimate beneficiaries. Thus the tax payable by the SPV cannot exceed the tax payable by the collective pool of investors. This leads to a practical problem, as the investors would be taxable under different slabs of income.

Section 164(IA) also says that income taxed in the hands of the representative assessee (as defined in Section 160(1)(iv)) would be taxed on the gross amount at the maximum marginal rate, if such income consists of profits and gains of business. The SPV as mentioned earlier is a mere conduit, it does not carry on any business.

Though the share of each beneficiary is known, it is virtually impossible to decipher whether a beneficiary is holding the securities issued by the SPV as stock in trade or as an investment. If the beneficiary (investor) holds the securities as stock in trade, in the course of its business then this proviso might come into play. Moreover in India since most securities issued by SPVs are not listed, there is no secondary market to speak of.

It is likely that the private placements of such securities would constitute investment in the hands of most beneficiaries.

Ultimately however, there is no tax incidence on the SPV as the tax paid in a representative capacity can be recovered from the interest payments to the investor as per the provisions of Section 162.

H. The Global View

So far, securitisation of debt assets in India, has been restricted to domestic shores. Neither have SPVs been set-up offshore, nor have the debt instruments been issued abroad. This however, is not an impossibility.

Payments of interest to non-residents will attract withholding tax. In fact, if the assets which are securitised are not transferred under a “true sale agreement” to the SPV, withholding tax may also be imposed on the rentals passed on to the offshore SPV. Even when the asset itself (for e.g. the hire purchase receivables) is transferred to the offshore SPV, the payments made to such SPV may be subject to a withholding tax. In fact, even now, the implications of whether withholding tax rules are applicable when the income arising out of the receivables is passed on to the domestic SPV remains unclear.

If the SPV is set up off-shore it is likely that the servicer will make all payments on behalf of the offshore SPV. It can thus be argued that only those obligations of the SPV which result in payments to offshore parties should be subject to withholding tax.

The SPV should be located in a suitable treaty country, whereby under the double tax avoidance agreements the rates of withholding tax are the lowest. Else, it is also possible to ensure that the securities are initially subscribed for by a vehicle located in such a country. This vehicle should then repackage the securities and issue them to the ultimate investor. Such a technique is common abroad in case of straight bond issues.

Parties to a securitisation deal have adopted various mechanisms to reduce or eliminate withholding tax. Besides taking advantage of the double tax avoidance treaties, the mechanisms include, taking advantage of domestic tax laws or even swap arrangements.

In August 1996, Thai Cars issued FRNs aggregating to US$ 250 million which were secured on auto-loan receivables. Thai tax laws call for a withholding tax rate of 15 per cent on payments of interest to non-residents. An offshore/onshore swap arrangement was used to reduce the level of withholding taxes.

Under the offshore leg of the swap, the US dollar issue proceeds were swapped into Yen by Thai Cars, a Cayman Isle incorporated company. A Yen loan was made to Tru-Lease a Thai company. Under the onshore swap, Tru-Lease in turn swapped the Yen into Thai's domestic currency -- Baht and on lent these funds to the originator.

The interest payments between Tru-Lease and Thai Cars were subject to withholding tax, but the interest payments are based on Yen interest rates which were lower than the dollar, Libor or even baht interest rates. Thus, the incidence of withholding taxes was reduced.

With the sole exception of Hong Kong all countries in Asia, including India, impose withholding tax on payments of interest to non-residents. Australia recently took advantage of domestic law exemptions to circumvent withholding tax. Securitisation was undertaken by Macquarie Bank through an SPV whose sole business involves issuing and trading in debt securities. This is a qualifying business for the purpose of withholding tax exemption. It successfully issued notes of US $912 million in the Euromarket. Though withholding tax of 10 per cent would normally have been applicable, under this structure payments of interest to the noteholders was made free of withholding tax.

The contents of this paper should not be construed as legal opinion or professional advice.

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