Annex 1

A. SECURITIZATION IN INDIA

Securitization in India began in the early nineties, with CRISIL rating the first securitization program in 1991-92. Initially it started as a device for bilateral acquisitions of portfolios of finance companies. These were forms of quasi-securitizations, with portfolios moving from the balance sheet of one originator to that of another. Originally these transactions included provisions that provided recourse to the originator as well as new loan sales through the direct assignment route, which was structured using the true sale concept. Through most of the 90s, securitization of auto loans was the mainstay of the Indian markets. But since 2000, Residential Mortgage Backed Securities (RMBS) have fuelled the growth of the market.

The need for securitization in India exists in three major areas - Mortgage Backed Securities (MBS), the infrastructure Sector and other Asset Backed Securities (ABS). It has been observed that Financial Institutions/banks have made considerable progress in financing of projects in the housing and infrastructure sector. It is therefore necessary that securitization and other allied modalities get developed so that Financial Institutions/Banks can offload their initial exposure and make room for financing new projects. With the introduction of financial sector reforms in the early nineties, Financial Institutions/banks, particularly the Non-Banking Financial Companies (NBFCs), have entered into the retail business in a big way, generating large volumes of homogeneous classes of assets (such as auto loans, credit cards). This has led to attempts being made by a few players to get into the ABS market as well. However, still a number of legal, regulatory, psychological and other issues need to be sorted out to facilitate the growth of securitization in India.

A.1. Current Scenario in India

Securitization in India adopts a trust structure with the underlying assets being transferred by way of a sale to a trustee. Albeit a trust is not a legal entity, a trustee is entitled to hold property, which is distinct from the property of the trustee or other trust properties held by him. Thus, the trust is termed as a Special Purpose Vehicle (SPV). The SPV issues securities that are either 'Pass Through Securities' or 'Pay Through Securities (PTS)'. In case of Pass Through Securities, the investors holding them acquire beneficial interest in the underlying assets held by the trustee. Whereas, in case of PTS, investors holding them acquire beneficial interest only in the cash flows realised from the underlying assets and that too in order of and to the extent of the obligation contracted with the holders of the respective senior and subordinated branches of PTS. Under either scenario, the legal ownership of the underlying assets continues to vest in the trustee.

Mortgage Backed Securities (MBS)

In 2004-05, the Mortgaged Backed Securities market grew moderately at 13% with the issuance valued at Rs. 33.4 billion. There was also an increase in the 'par' transactions with all 15 transactions being made in 2005 having a 'par' structure. Since the underlying home loans in MBS pool have a floating-rate, the scheduled cash flow on such pools is uncertain and liable to change, depending on actual interest rate. Moreover, options to convert from fixed to floating rate and vice-versa, coupled with negotiated re-pricing of loans, added to the uncertainty of the cash flow in the MBS pool.

With the underlying loans earning floating rates, Pass Through Certificates (PTCs) in MBS issues are also being predominantly priced on a floating rate basis. In 2005, 52% of issuance was based on a floating rate. But given the significant expansion in the housing finance business, there is room for even more significant expansion in the MBS market. However, the long-term tenure of MBS and the lack of liquidity in the secondary market discourage investors from getting actively involved in the market. Also home loans in India get pre-paid or re-priced, thus exposing the structures to significant interest rate risk and leading to higher credit enhancement requirements.

Asset Backed Securities (ABS)

In 2005, the market for Structured Finance (SF) grew by 121% in terms of value and 41% in the number of transactions, while the ABS market doubled from Rs. 80.9 billion in 2004 to Rs. 222.9 billion in 2004. ABS was the largest product class, accounting for 72% of the SF market in 2005. This was three times higher than the volume of Rs. 81 billion in 2003. The growth in ABS issuance was the result of the following factors:

- Continued increase in disbursements by key retail asset financers,
- Investors familiarity with the underlying asset class,
- Relatively shorter tenure of issuances,
- Stability in the performance of a growing number of past pools.

Table A1: Trend in Structured Finance Volumes (Rs. billion)

Type	2001-02	2002-03	2003-04	2004-05
ABS	12.9	36.4	80.9	222.9
MBS	0.8	14.8	29.6	33.4
CDO/LSO	19.1	24.3	28.3	25.8
PGS	4	1.9	0	16
Others	0	0.4	0.5	10
Total	36.8	77.7	139.2	308.2

(CDO; Corporate Debt Obligations, LSO; Loan Sell off, PGS;Partial Guarantee Structure)

Another important aspect of recent ABS issuance is the increasing preference of floating rate yields. In 2005, 13% of the PTCs issued had a floating rate yield while the corresponding figure for 2004 was only 6%. Repackaged securities was also introduced, where in the cash flow on certain existing PTCs issued under an ABS transaction are acquired by a SPV and fresh PTCs are issued against the same.

Given that the Asset Backed Securities are still new for the investors in India market, their preference is for AAA/AA rated instruments as there is no market for the subordinated paper or 'Junk Bond'.

In 2005, Rs. 2.8 billion worth of Corporate Debt Obligations (CDO) and Rs. 23 billion worth of individual corporate loans were securitised. The impeding factor in CDO growth is that, investment decisions in the CDO pool are influenced by base rating of the underlying corporate exposures.

A.2. Issues facing Indian securitized market

A.2.1. Regulatory issues

Stamp Duty: One of the biggest hurdles facing the development of the securitization market is the stamp duty structure. Stamp duty is payable on any instrument which seeks to transfer rights or receivables, whether by way of assignment or novation or by any other mode. Therefore, the process of transfer of the receivables from the originator to the SPV involves an outlay on account of stamp duty, which can make securitization commercially unviable in several states. If the securitized instrument is issued as evidencing indebtedness, it would be in the form of a debenture or bond subject to stamp duty. On the other hand, if the instrument is structured as a Pass Through Certificate (PTC) that merely evidences title to the receivables, then such an instrument would not attract stamp duty, as it isn't an instrument provided for specifically in the charging provisions.

Among the regulatory costs, the stamp duty on transfers of the securitized instrument is again a major hurdle. Some states do not distinguish between conveyances of real estate and that of receivables, and levy the same rate of stamp duty on the two. Stamp duty being a concurrent subject, specifically calls for a consensual legal position between the Centre and the States.

A.2.2. Foreclosure Laws:

Lack of effective foreclosure laws also prohibits the growth of securitization in India. The existing foreclosure laws are not lender friendly and increase the risks of MBS by making it difficult to transfer property in cases of default.

A.2.3. Taxation related issues

Tax treatment of MBS SPV Trusts and NPL Trusts is unclear. Currently, the investors (PTC and SR holders) pay tax on the income distributed by the SPV Trusts and on that basis the trustees make income pay outs to the PTC holders without any payment or withholding of tax. The view is based on legal opinions regarding assessment of investors instead of trustee in their representative capacity.

It needs to be emphasized that the Income Tax Law has always envisaged taxation of an unincorporated SPV such as a Trust at only one level, either at the Trust SPV level, or the Investor/Beneficiary Level to avoid double taxation. Hence, any explicit tax pass thro regime if provided in the Income Tax Act does not represent conferment of any real tax concession or tax sacrifice, but merely represents a position that the Investors in the trust would be liable to tax instead of the Trust being held liable to tax on the income earned.

Amendments need to be made to provide an explicit tax pass thro treatment to securitization SPVs and NPA Securitization SPVs on par with the tax pass thro treatment applied under the tax law to Venture Capital Funds registered with SEBI.

To make it certain that investors as holders of Mutual Fund (MF) schemes are liable to pay tax on the income from MF and ensure that there is no tax dispute about the MBS SPV Trust or NPA Securitization Trust being treated as an AOP(Association of Persons), SEBI should consider the possibility of modifying the Mutual Fund Regulations to permit wholesale investors (investors who invests not less than Rs. 5 million in scheme) to invest and hold units of a closed-ended passively managed mutual fund scheme. The sole objective of this scheme is to invest its funds into PTCs and SRs of the designated MBS SPV Trust and NPA Securitization Trust.

Recognizing the wholesale investor and Qualified Institutional Buyers (QIB) in securitization Trusts, there should be no withholding of tax requirements on interest paid by the borrowers (whose credit exposures are securitized) to the securitization Trust. Similarly, there should be no requirement of withholding tax on distributions made by the securitization Trust to its PTC and/or SR holders. However, the securitization Trust may be required to file an annual return with the Income-tax Department, Ministry of Finance, in which all relevant particulars of the income distributions and identity of the PTC and SR holders may be included. This will safeguard against any possibility of revenue leakage.

A.2.4. Legal Issues

Listing of PTCs on stock exchange: Currently, the SCRA definition of ‘securities’ does not specifically cover PTCs. While there is indeed a legal view that the current definition of securities in the SCRA includes any instrument derived from, or any interest in securities, the nature of the instrument and the background of the issuer of the instrument, not being homogenous in respect of the rights and obligations attached, across instruments issued by various SPVs, has resulted in a degree of discomfort among exchanges listing these instruments. To remove any ambiguity in this regard, the Central Government should consider notifying PTCs and other securities issued by securitization SPV Trust as ‘securities’ under the SCRA.

Some issues under the SARFAESI Act: The ambiguity about whether or not Asset Reconstruction Companies (ARCs) and Securitization Companies (SCs) registered with the RBI can establish multiple SPV Trusts, has been resolved by a specific provision in the form of sec.7 (2A) of the SARFAESI Act. In view of this, it is now possible to unambiguously adopt the trust SPV structure even under the SARFAESI Act for MBS, ABS or NPL securitization.

The current definition of ‘Security Receipt (SR)’ envisages SR to be the evidence of acquisition by its holder of an undivided right, title or interest in the financial asset involved in securitization. This definition is appropriate and sufficient for securitization structures where securities issued are all characterized as ‘Pass Through Securities’.

However, where the SPV Trust intends issuing Pay Through Securities with different classes or branches having senior or subordinated rights to the cash flow from realization of financial assets, the current definition of a SR may prove legally inadequate. There is need for an amendment that enables the SR to also be an evidence of the right of its holder to the cash flows from realization of the financial asset involved in securitization.

The construct of the SARFAESI Act is such that it enables SRs to be issued to and held by Qualified Institutional Buyers (QIBs), but does not include NBFCs or other corporate bodies, unless they are notified either by the Central Government as financial institution.

In order to deepen the market for SRs, there is a need to broad base the investor base that qualifies to invest in SRs. With a view to deepen the investor base of QIBs which can invest in SRs, it is suggested that NBFCs and non-NBFCs with owned net funds in excess of Rs.500 million be permitted to invest in SRs as QIBs. Similarly, private equity funds registered with SEBI as venture capital funds may also be permitted to invest in SRs within the limits that are applied for investment by venture capital funds in corporate debt instruments.

A.3. Recent Developments

In the 2005-06 budget, the Finance Minister made certain proposals to strengthen the capital market. The following are a list of the measures proposed in the budget to bolster the corporate bond market:

- Amending the definition of ‘securities’ under the Securities Contracts Regulation Act, 1956 so as to provide a legal framework for trading of securitized debt including mortgage backed debt
- Appointing High Level Expert Committee on Corporate Bonds and Securitization to look into the legal, regulatory, tax and market design issues in the development of the corporate bond market.

These measures are expected to open up new opportunities for international investors to take part in the growing Indian economic boom. The amendments will allow securitized debt to be traded on the stock exchanges, which will widen and deepen liquidity in the debt markets leading to efficient pricing of risks. Securitization, by diversifying away borrower default risk, should attract new market participants including foreign institutional investors. This will enable easier access to long-term debt for infrastructure projects.

In February 2006, the RBI has released its final guidelines governing the securitization of performing assets in India in response to a High-Level Committee report. These final guidelines will have a definite impact on several issues and should enable the development of a vibrant and robust securitization market.

Some of the positive aspects of the recent notification are as following:

- A clear definition of what constitutes first and second loss credit enhancements.

The guidelines clearly define first and second loss credit enhancements. First loss represents the credit enhancement required to raise the rating of the instrument to an investment grade rating. Second 1oss represents the incremental credit enhancement to achieve the final rating of the instrument. This definition is a crucial step in the right direction, as it would enable the market to operate on a commonly shared understanding on an issue that has been the subject of much speculation and debate. Besides, it enables harmonization of credit enhancement across transactions, and facilitates comparison and analysis, which are a pre-requisite for potential second loss services provision by third parties.

- Confirmation that exposures to securitization transaction will be classified as exposures to the underlying assets.

Investments in securitization transactions have been classified to represent exposure to the assets owned by the trust. This is a crucial notification, as several investors in the past insisted on classifying SPV Trusts as conventional corporate credit exposures, being uncomfortable with the ambiguity on this issue. This clarification puts the subject to rest. It is also expected that investors will be able to use securitization as an effective means of obtaining exposure to directed lending in priority sectors, such as Small Road Transport Operators (SRTOs), agricultural lending and small home loans.

- Encouragement of active third party involvement in transactions.

This is the most positive aspect of the guidelines as it represents a paradigm shift with respect to securitization transactions. The guidelines actively encourage the participation of third parties, which is expected to increase transparency and create a vibrant market for independent service providers. It will facilitate a preferential capital treatment in comparison to the originators, if they choose to provide second loss credit enhancement. They will need to provide capital at a risk weight of 100% vis-à-vis a complete write-off of capital if the originator provides second loss enhancement. At least 25% of the liquidity enhancement provided in the transaction will need to come from an independent third party other than the originator.

This recommendation symbolizes a clear shift in the regulator's approach to the product and it reflects the need to build a healthy third party participation in the market. Several market participants have shown great deal of interest in providing these services. Insurance companies, both private and public, have also expressed interest in providing credit insurance solutions, which will tremendously increase the depth and vibrancy of the market.

The guidelines are also expected to increase transparency on disclosures of securitization exposures by originators.

However some provisions of these guidelines are expected to have an adverse impact on market growth in the short term. Originators will face challenges on account of:

- Continued ambiguity on the applicability of the guidelines for past transactions and for direct assignment of loan receivables.

The mode of implementation of the guidelines whether retrospective or prospective, has not been specified yet. The guidelines indicate that implementation for past transactions would be under taken on a case-by-case basis. But given the significant impact that this decision could have on the financial and capital position of banks and financial institutions, a clear directive on the issue would be appropriate.

- Prohibition of upfront profit recognition in securitization despite a complete sale of assets to the SPV.

The guidelines prohibit profit recognition on securitization transactions at the time of sale. Profits need to be amortized over the tenor of the transaction. This is a departure both from the draft guidelines issued by the RBI in April 2005 and from past lCAI (Institute of Chartered Accountants of India). Assuming that the transaction has passed the required tests of true sale and represents a fixed limited downside risk for the seller, the denial of profits could be considered onerous. Besides it would create a deferred tax asset as the sale and profit will be recognized for income tax computation. This move is expected to impact market attractiveness for the product, as profit recognition has been one of the motivations for several originators.

A.4. Conclusion

The RBI guidelines thus provide a robust regulatory and institutional framework for the orderly development of the securitization market in the long term. At the same time the guidelines have eliminated some incentives for securitization. This will lead to temporary reduction in issuance volume. However, in the medium and long term, the securitization market is expected to witness reasonable growth.

The stringent norms presently proposed on capital allocation for credit enhancements will drive originators towards mezzanine strips. Consequently, a new class of investors in these products, who are comfortable with sub-AAA exposures, is expected to emerge. Thus large banks and financial institutions are expected to enter the market actively as investors. The proposed guide lines on Basel II implementation for banks, providing significant capital relief for investments in bonds with high credit ratings, is also expected to enhance the demand for AAA/AA paper which can be efficiently structured into securitization transactions. With the proposed recognition of PTCs as securities under the SCRA, and the subsequent listing of PTCs, interest from both domestic as well as foreign investors will witness a rise.