To,
Vivek Singh,
Assistant General Manager
Financial Markets Regulation Department,
Reserve Bank of India
Mumbai

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Sub: Representation on needed reforms for securitisation

Respected Sir,

About the Indian Securitisation Foundation

The **Indian Securitisation Foundation**[1] is a not-for-profit entity representing the securitisation industry in India. The membership of the Foundation includes banks, NBFCs, microfinance institutions, other issuers and investors and securitisation professionals for promoting interest of securitisation and fixed income securities in India. Investors in securitisation include public sector banks, private sector banks, mutual funds, insurance companies and others.

Our Representations:

This representation contains our major recommendations pertaining to the securitisation market. The major recommendations are grouped under the following heads:

a. Income Tax;
b. Stamp Duty;
c. FII investments;
d. Reviews in the RBI framework;
e. Allowing Insurance companies to participate;
f. Introducing covered bonds;

[1]License u/s 25 of the Companies Act 1956 received vide letter No.ROC/25(1)/SRN B67046052/258/3/2013/6187 dated 20 March, 2013. http://indiansecuritisation.com/

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Recommendations under the Income Tax Laws:

The Finance Act 2013, after receiving lots of representations and concerns from the industry, came up with a special tax regime for the securitization trusts. However the element of distribution tax disappointed the industry expectations. Under the present provisions of the Income Tax Act (IT Act), securitization trusts are required to pay tax at the rate of 25% or 30% (depending on the recipient assesse) on the distributed amount.

The distribution tax imposed on securitisation transactions is completely misplaced and has proved counter-productive. There is no need for exemption of investors' income – investors may pay tax on the income distributed by the trust, and the trust may pay tax on income not distributed by it, if any.

The major problems faced by the securitization companies along with our recommendations are tabulated below for reference:

Sl. No.	Issues faced by the industry	Current Provisions	Recommendations
1.	Imposition of distribution tax on the distributed amount to the investors.	Income distributed by the securitization companies are exempt in the hands of the investors.	In compared with other fund structure such as REITs and VCFs/VCUs, the tax should be levied in the hands of the investors and distribution tax should be removed.
2.	Special tax regime covers only two categories of securitization trusts.	Under the current tax regime, definition of "securitisation trust" envisages only trusts under the SEBI Regulations or under the RBI Guidelines.	The scope of section 10(23DA), which exempts the income of securitization trust, should be broaden to cover other categories of trusts as well: a. Trusts formed in the context of securitisation by HFC's; b. Trusts formed by Asset Reconstruction

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			Companies for the purpose of securitising non-performing assets under the SARFAESI Act; c. Trusts formed by corporates (other than banks or NBFCs) especially in the infrastructure space, that could securitise any other stream of receivables
3.	Prevailing uncertainties on the taxation of trusts on the past transactions (i.e. pre special regime announcements)	The special tax regime is applicable for financial year 2014-15 onwards. Before the introduction of special regime the taxation of the SPV / trust issuing PTCs to beneficiaries/ investors, whose shares are determinate, is governed by the general provisions relating to trust taxation under section 61 read with section 161(1) of the Act.	In order to remove the uncertainties following are the two options: a. To provide clarifications that the provisions pertaining to section 161(1A) of the IT Act shall not apply to securitization trusts; or b. Exemption u/s 10(23DA) should be made retrospectively
4.	Loss of TDS credit as the income accruing to the SPV are subjected to TDS	Currently the income accruing to the trust are subjected to TDS and the credit portion is not received by the securitization trust.	Specific provision under section 196 of Act should be inserted in order to clarify that any payments to SPV should not be subjected to any TDS
5.	Disallowances of expenses in the hands of investors	As the income received from the securitization trust are exempt in the hands of investors, Section	Taxing income in the hands of investors will resolve the same issue

		14A read with Rule 8D will get attracted which will disallow the expenses incurred by the investors	

Stamp duty

Stamp duty exemption has been given in case of assignment of receivables to a factor, by amending the Stamp Act. Similar exemption needs to be given by exempting assignment of receivables for the purpose of securitisation to a securitisation trust.

FII investments

FIIs are currently not permitted to make investments in securitised paper, though they are allowed to invest in security receipts backed by non-performing assets. This is an anomaly and must be removed soonest.

Reviews under RBI framework:

The RBI guidelines on securitisation, of 2012, were drawn in the backdrop of the global subprime crisis where securitisation and CDOs were seen as a major culprit. That mindset has subsided globally. Therefore, the RBI must review its restrictive guidelines, particularly in respect of the following:

- The MRR requirement of 10% is double of the global benchmark, and is counterproductive.
- Globally, regulations have provided exemption to prime residential mortgage securitisations from the requirement of MRR. With a historical default rate of 0.5%, the need for 10% MRR is abnormal, and has curbed the residential mortgage securitisation market in the country.
- RBI's prohibition on re-securitisation, that is, securitisation of loans/bonds acquired by a financial entity, is curbing the liquidity and activity in the loan market. This was a reaction in the wake of the CDO business, and now that CDOs are making an impressive come-back globally, there is no reason for that prohibition to remain.
- RBI also put a bar on synthetic CLOs. This is also counter productive, and has only contributed to keep the CDS market a non-starter.

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In addition to the above, the current market in India is entirely a PTC driven market, whereas globally, securitised instruments include bonds, notes and a variety of fixed coupon instruments. Globally, SPVs are not merely trusts – there are companies, LLPs etc serving as SPVs. While the 2006 securitisation guidelines of the RBI clearly permit SPVs to have any organisational form, the Department of Nonbanking Regulation in the RBI seems to have taken a view that SPV formed as a company will become an NBFC. This view is neither correct, nor desirable.

The RBI has considerably relaxed the ECB framework recently. Since securitised debt instruments are obviously rupee-denominated, at least for the issuer, there is a case for opening up cross border issuance of securitised paper. This is particularly so in case of RMBS transactions which are long-run assets, backed by a strong collateral.

Covered bonds

Globally, covered bonds are an alternative instrument to securitisation. In India, covered bonds were recommended by way of a comprehensive report of the Working Group appointed by the NHB. However, almost 2 years after the report, no tangible action seems to have happened on this front.

Permitting Insurance Companies to invest in Asset backed Securities

Based on our understanding of the extant regulations with regard to investments by insurance companies, we humbly submit that currently investment in ABS with underlying assets being housing loans/ infrastructure assets ("***Permitted ABS***") has been permitted to insurers under the IRDA (Investment) (Fifth Amendment) Regulations, 2013. Investment in ABS with other underlying assets (Other ABS) is not expressly permitted.

While the intent of the lawmakers is well placed to allow insurance companies to invest in securitised instruments and other securities for promoting infrastructure and social sector, however the intent could not have been to keep investment in securitised paper limited to securities having underlying assets as housing loans/ infrastructure assets only. As investment in Permitted ABS provides for diversification of investment pool, the rationale for not permitting Other ABS is not understood.

Current state of the Indian securitisation market

We understand that it may be important to provide some quick facts and features of the Indian securitisation market, for the rest of our representation to be better appreciated.

- **PSL-driven market**: Strange though it may seem in international context, the securitisation market in India is almost entirely driven by the so-called priority-sector-lending market. Several banks, particularly those not with strong branching, fail to achieve the targets of priority sector lending, and, thus, have to acquire priority-sector loan portfolios from others, primarily NBFCs. Globally, most securitisation transactions happen for economic reasons – the investor is looking at building up a loan//investment book by investing in securitised assets. However, in India, the motive of securitised investments driven by considerations of building an investment or credit portfolio seems largely missing;

- **Direct assignments rule the market:** This is also an aberration in international terms. Globally, whole loan sales, termed as "direct assignment" in Indian parlance, are a distinct segment altogether. There is no "securitisation", that is, transformation of the loans into securities, in case of direct assignments – hence, these transactions are never included in the statistics of securitisation. However, in India, transactions have largely tended to move from securitisation format to direct assignment format, particularly after introduction of distribution tax in 2013;

- **Mutual funds and asset managers shy away from the market:** Mutual funds were significant investors in the securitisation markets till 2011. Investment in securitised debt instruments make eminent sense for a mutual fund, as generally, despite strong ratings and performance, the yields in securitised debt instruments are better than in case of a corporate bond. However, tax disputes were raised by tax officers in Mumbai circa 2011. The contention of the tax officers was that the securitisation SPV was an "association of persons" for tax purposes, and given the fact that the investor in the instrument, being a mutual fund, was not paying tax (mutual funds are exempt from taxes), the SPV was liable to be taxed at maximum marginal rate. On the face of it, if the tax transparent status of the fund was a reason to impose the tax on the SPV, the same is the case with any investment by a mutual fund in a debt security – while the issuer of the security gets a tax deduction, but the fund itself does not pay tax. It is a different issue that there are no clearly defined rules for tax transparency for funds and SPVs in India – however, it is weird to see tax officers trying to take advantage of lack of clarity in the law, particularly when there is no case of a revenue leakage at all. This controversy caused all mutual funds, en masse, to exit from securitisation investments. Unfortunately, though the Income-tax Act was specifically amended in 2013 and the distribution tax provisions are explicitly inapplicable in case of mutual funds, mutual funds have not been investing in securitisation transactions even now. Our interaction with leading fund managers establishes that they will not do so until the pending tax litigation is cleared, as their tax counsel have advised that if they now take shelter under the explicit exemption available under sec 115TA, they will be implicitly admitting that, for the years when such explicit exemption was not available, their income was indeed liable to tax. The irony is that the investors in the mutual funds have all exited by now; and the tax, at the maximum marginal rate of 30%, is being demanded from the fund managers who earn meagre management fees;

- **Negligible RMBS activity:** While world-over, residential mortgage backed securities (RMBS) account for the largest part of securitisation market, in India, RMBS is negligible. This is despite NHB running a platform for RMBS transactions, on which the last transaction may have happned around 2011. The presence of stamp duty and its inter-state complexities, and the fact that RBI requires a minimum risk retention of 10% whereas the historical default rates of housing finance in India have been within 0.5%, are among reasons to explain the lack of any RMBS activity. Also, perhaps, the fact that most of the larger HFCs in India have a AAA-rating or close thereto may also disincentivise them to search for any rating or cost arbitrage by opting for RMBS funding;

- **Banks absent as sellers:** This is yet another striking feature of the Indian securitisation market – banks are buyers, primarily for their PSL requirements, but banks are not originators or sellers in the market. This is despite the fact the implementation of Basle III poses stiff capital adequacy burden on the banks. The reason may lie either in the too high equity tranche requirements imposed by rating agencies, whereby the possibility of a significant capital relief gets negated, or sheer inertia, since none of the leading PSU banks have securitised any of their assets.

- **Volumes declining over 3 years in a row:** As a combined result of the several regulatory and taxation issues mentioned elsewhere in this Note, securitisation volumes in India have declined over the last 3 years. The subprime crisis did affect investors,in the sense that it did invoke caution, however, the decline in volumes of securitisation has nothing to do with the subprime crisis or investor apathy. It is largely due to the distribution tax, and low incentives to securitise non-priority sector assets due to high MRR requirements.

- **Negligible listed securities:** While SEBI did enact a separate listing window for securitised debt instruments, currently subsumed in the Listing Obligations and Disclosure Requirements Regulations, 2015, there have been only a couple of listed issuances so far. There is, actually, no incentive for listing. Unlike in case of bonds, which become eligible investments for FIIs once they are listed, securitised debt instruments do not apparently qualify as eligible investments for FIIs.

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- **No cross-border issuance or investment by FIIs:** The fact that FIIs are not allowed to invest in securitised paper has already been mentioned above. This is an anomaly, that has gone unrectified for several years now. Note that the RBI's rules on Issue and Transfer of any Foreign Security do permit FIIs to invest in security receipts; however, they do not permit investment in pass through certificates or other securitised paper. At the same time, securitised debt instruments are regarded as ECBs, and since ECB option is generally not allowed in case of financial sector entities, cross-border issuance of securitised debt is nil. The RBI has recently significantly liberalised the ECB framework, particularly as regards rupee-denominated ECBs. Since securitised debt instruments are obviously rupee-denominated, the RBI may take a pragmatic view and permit cross-border securitisation, particularly in case of RMBS transactions.

Thanking you

For **Indian Securitisation Foundation**

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