To,
Mr. Neeraj Nigam
Chief General Manager-in-Charge
Department of Regulation
Reserve Bank of India
12th Floor, Central Office Building,
Shahid Bhagat Singh Road
Mumbai – 400 001

Sub: Representation for the development of a regulatory framework for issuance of covered bonds in India

Dear Sir/Ma'am,

We, Indian Securitisation Foundation, on behalf of the structured finance industry in the country wish to draw your attention to the increased issuances of covered bonds in India despite the absence of a specific legal or regulatory framework.

To discuss briefly about the instrument, covered bonds are dual recourse instruments, where the investors have dual recourse – first, on the issuer, and second, on the cover pool, or pool of assets which are offered as security, in a manner such that the assets may remain protected from the bankruptcy of the issuer.

Covered bonds have been in existence for over 250 years, issued for the first time in the 18th century in Prussia, and has been the primary source of funding of residential mortgages, ships or public sector funding in almost whole of Europe ever since. Lately however, the European Banking Authority has been working on a concept of European Secured Notes, which are similar instruments offering dual recourse to the investors, however, meant for non-traditional asset classes like small and medium enterprises loans, green assets, social infrastructure assets, etc.

The instrument issued by the name of the covered bonds or dual recourse bonds, was however, issued in India in 2018-19 for the first time.

In the financial year 2020-21, India witnessed issuance of covered bonds worth INR 2200 crores, which is at a CAGR of 346.05% since the first year of issuance and a454.5% growth from the year before.

A detailed description of the state of covered bonds in India and globally forms part of Annexure.

It is worthwhile to note here that world-over, issuances covered bonds are either supported by dedicated legislations or regulatory framework. The Indian market has currently started without either a legislative backing, or a regulatory recognition.

In the past, the National Housing Bank, in an attempt to introduce covered bonds in India, had formed a committee under the chairmanship of Shri Ananta Barua in 2012[1]. The Committee had suggested formulation of a regulatory framework for the issuance of covered bonds. Subsequently, the Corporate Bonds and Securitisation Advisory Committee of the Securities and Exchange Board of India also deliberated on the issue. However, nothing came out of any of these initiatives.

Given the market is still at a primitive stage, but shows a lot of promise. As we mentioned earlier, Europe has embarked upon this time tested instrument for financing SMEs, and the need for small business finance and financial inclusion is similar, if not more, in India. If devices such as covered bonds can provide a cheaper borrowing option to originators, and better rated fixed income instrument to investors, it is a win-win proposition.

However, it would be ideal if the regulatory framework may recognize covered bonds, and also have some minimal rules for adherence. In particular, several countries have set limits of the extent to which covered bonds may be issued as a percentage of the total assets. There are other operational safeguards that we may allude for the sake of detailed discussion.

In case of any clarifications, please reach out to us.

Thanking you,

For **Indian Securitisation Foundation**

VINITA NAIR Digitally signed by VINITA NAIR Date: 2021.08.12 16:16:48 +05'30'

Vinita Nair
Director
Date: August 12, 2021

[1] https://www.nhb.org.in/Whats_new/NHB%20Covered%20Bond%20Report.pdf

Annexure I: About Covered Bonds

Covered bonds are a hybrid between asset-backed securities/mortgage-backed securities and normal secured corporate bonds. They are an instrument of refinancing, primarily used by mortgage lenders. Unlike secured corporate bonds which provide recourse against the issuer, covered bonds provide a bankruptcy-protected recourse against the assets of the issuer (cover pool) too. Unlike mortgage backed securities which merely provide recourse against the pool of assets, covered bonds provide an additional recourse against the issuer too.

Features

- Covered bonds are an on-balance sheet instrument. The cover pool stays on the balance sheet of the issuer;
- The first recourse in case of covered bonds is on the issuer. Hence, issuer has full skin-in-the-game. Further, the second recourse lies on the ring-fenced cover pool. This makes covered bonds a dual recourse instrument;
- The cover pools is usually a dynamic pool with assets ring-fenced to form part of it i.e. the issuer may add or remove identified assets into the pool on on-going basis. Due to ring-fencing of the assets in the cover pool, covered bondholders have a priority over other creditors against the cover pool to the extent of the money due to them;
- The cover pool typically has a pre-defined over-collateralisation cover;
- Cover pools are structured to be bankruptcy remote;
- Covered bonds are prepayment protected. While issuer keeps a call option, the risk of prepayment of the underlying assets is entirely passed to the investors;
- Ratings of covered bonds are typically between (higher than) corporate bonds, and (lower than) mortgage backed securities. Due to the support of cover pool, the rating of covered bonds is a few notches above the rating of the issuer;
- Covered bonds operate on asset-liability mismatches. The repayment of covered bonds mostly happens by way of a bullet repayment. However, the assets in the cover pool are repaid on a regular basis. Hence, there is an inherent asset (cashflows from the pool) and liability (redemption of the bond) mismatch.

Benefits of Covered Bonds

For the issuer

- Covered bonds are an alternative source of finance for issuers other than traditional bonds and asset-backed securities;
- Since the assets forming part of the cover pool remain in the books of the issuer, until there is a default, they do not result into contraction of balance sheet of the issuer;
- Covered bonds are a full recourse instrument. Hence, regulatory concerns on risk retention requirements as in case of ABS become completely inapplicable for covered bonds;
- In certain jurisdictions (usually Europe) covered bonds are eligible as collateral for central bank liquidity;
- The cost of issuance of covered bonds is usually lower as compared to the traditional unsecured/secured bonds;
- Covered bonds have lesser structural complexity as compared to ABS;
- These are an ideal instrument for less-than-AAA- rated issuers as they enable the issuer to get notched up rating, thereby also reducing borrowing cost of the issuer.
- Unlike PTCs, which are based on pass-through structures, cover pools underlying the covered bonds may be dynamic. Hence, they provide greater flexibility with respect to the collateral. As recently witnessed during the COVID-19 pandemic, one of the biggest difficulties was restructuring of underlying loans in securitisation transactions. It became difficult for originators to obtain trustees and investors' concurrence for restructuring of the loans. Had it been covered bonds; the issuer could have simply replaced loans without difficulty.

For the investor

- Since the first recourse in case of covered bonds is on the issuer, it ensures that the issuer has 100% skin in the game. This makes covered bonds safer investment avenue for the investors;
- Usually, covered bonds are repayable in a bullet installment. Hence, the cashflows from covered bonds are predictable;
- Unlike ABD, which are issued in various tranches with different risks and returns, covered bonds are usually issued in a single tranche;
- Investors have a dual recourse in case of covered bonds;
- The ratings of covered bonds are higher compared to that of secured bonds. Hence, they are a safer investment for the investors;
- Due to the feature of bankruptcy remoteness of the cover pool, covered bonds have the ability to avoid disruptions caused by insolvency or other moratoriums.

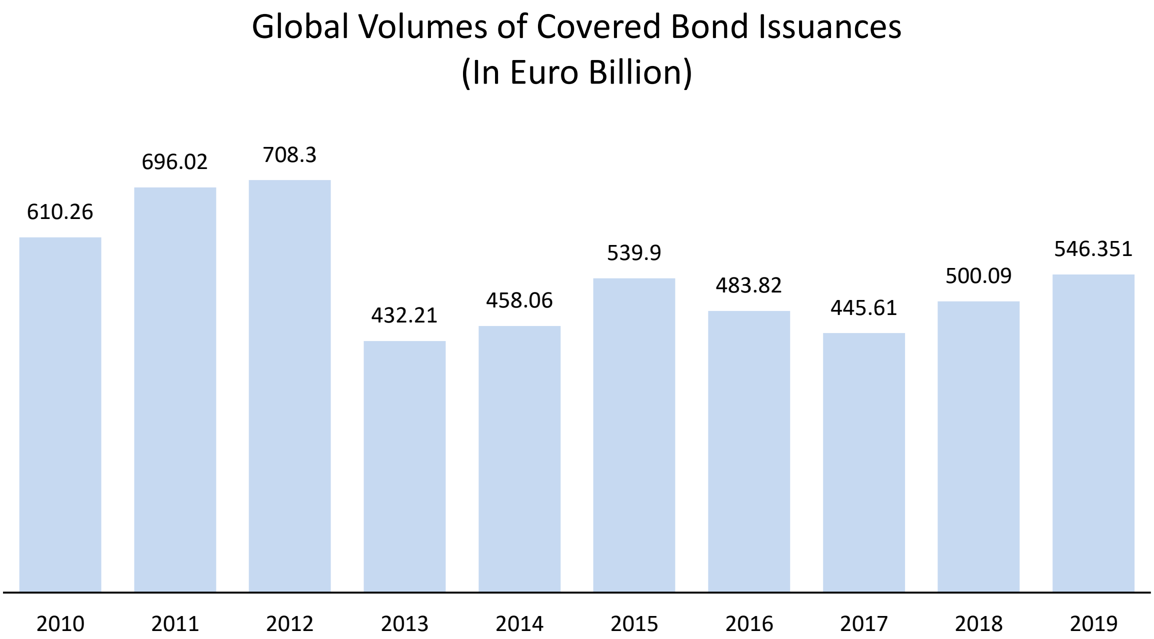
Global Scenario

Covered bonds have existed in Europe for over 250 years. Until recent years, covered bonds have essentially been a Continental European instrument, known by variety of names such as *pfandbriefe* in Germany, *realkreditobligationer* in Denmark, *obligations fonciers* in France, *pantbrev* in Spain, etc. However, the sub-prime crisis and the associated aversion for mortgage backed securities gave a new wave of popularity to covered bonds, spreading it to many new destinations such as USA, Australia, New Zealand, Canada, Korea, and Malaysia and so on.

Volumes

Currently, the global outstanding value of covered bonds is Euro 2.70 trillion. Covered bonds account for about 18% of Europe's GDP. The performance of covered bonds, however, subdued in FY 2020 and FY 2021 mainly due to COVID-19. Though, the volumes suffered significantly in the Q3 and Q4 of FY 20, but returned to moderate levels by the beginning of FY 2021.

The figure below shows the volumes of covered bond issuances globally:

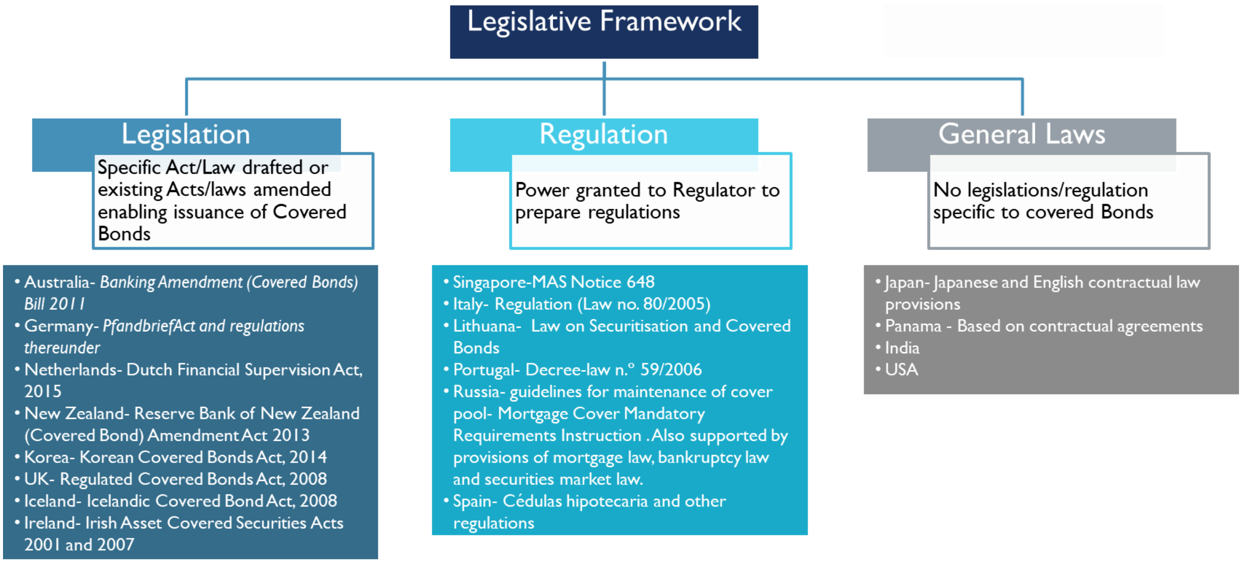


Source: ECBC Factbook, 2020[2]

[2] https://hypo.org/app/uploads/sites/2/2020/10/ECBC-Fact-Book-2020-Online.pdf

Legal and Regulatory Aspects

Over 35 countries including European countries and some non-EU countries have also issued specific legislations/regulations for covered bonds[3]. The regulatory framework for covered bonds may be in the form of a specific legislation or notifications/regulations specific to covered bonds. In absence of both, the issuances of covered bonds are based on general law framework.



Other Aspects

In the European region, covered bonds are usually backed by mortgage receivables, which is in contrast with the practice being followed in India. Recently, newer asset classes are being used to from cover pool for issuances of covered bonds. For example green covered bonds that are backed by loans qualifying for 'green' purposes.

Further, the European Banking Authority (EBA), in 2018, issued a report[4] on European Secured Notes (ESNs) which are 'covered-bond-like-dual recourse instruments' acting as an alternative source of

[3] Covered bond frameworks of several countries- http://www.ecbc.eu/framework/list

[4] https://www.eba.europa.eu/sites/default/documents/files/documents/10180/2087449/6fe04a31-ec0b-4ea1-9508-258ad2cf72d8/EBA%20Final%20report%20on%20ESNs.pdf

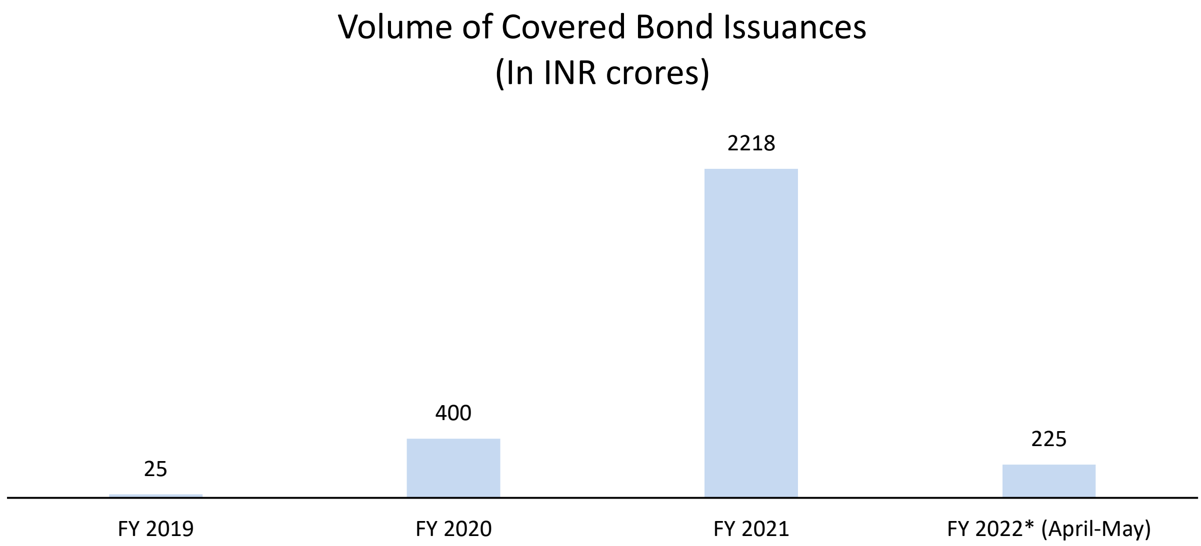
finance to banks engaged in SME lending. Essentially, they are covered bonds backed by a cover pool of SME loan receivables. The blueprint of ESNs was introduced in May 2021[5].

Indian Scenario

In the financial year 2020-21, India witnessed issuances of covered bonds worth INR 22 billion, which was an upsurge at CAGR of 346.05% from the financial year 2018-19 i.e. the first year of issuance of covered bonds in India. These issuances are expected to gradually increase in the upcoming years.

Issuances of Covered Bonds

The issuances of covered bonds in India initiated in 2019. Unlike the European covered bonds, which are usually backed by residential mortgages, Indian covered bonds are backed by various kinds of asset classes such as vehicle loans, gold loans, small business loans, microfinance loans, etc. Most of the covered bonds were issued in form of market linked debentures. A summary of the issuances of covered bonds in India has been provided in the Annexure. The figure below shows the volume of covered bond issuances in the country over the last few years:



Source: ICRA report on Covered Bonds, 2021[6]

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[5] https://hypo.org/app/uploads/sites/3/2017/05/ECBC-ESN-Blueprint-April-2021.pdf
[6] https://images.assettype.com/bloombergquint/2021-06/113451a0-3588-4cb4-a36d-2759bd0a48b7/ICRA_Covered_bond_Thematic.pdf

A snapshot of covered bond issuances in India can been seen in the below table:

Name of the Issuer	**Size (In INR crores)**	**Enhancements**	**Rating of Covered Bond**	**Rating of the Issuer**	**Cover Pool**	**Bankruptcy remoteness of cover pool achieved through**	**Whether Marked Linked?**
Kogta Financial India Limited	25	Over-collateralisation-18% CC- 5.85%	AA-	A	Vehicle Loans	Upfront sale of pool to SPV	No
Kogta Financial India Limited	20	-	AA	A	Vehicle Loans	Upfront sale of pool to SPV	-
Muthoot Fincorp Limited	125	Over-collateralisation - 15% CE - 7% (form not mentioned)	AA+	A+	Gold Loans	Upfront sale of pool to SPV	Yes
Muthoot Fincorp Limited	25	Over-collateralisation - 15% CE - 7% (form not mentioned)	AA+	A+	Gold Loans	Upfront sale of pool to SPV	No
Kogta Financial India Limited	20	-	AA	A	Vehicle Loans	Upfront sale of pool to SPV	-
Shriram Transport Finance Company Limited	1000	Over-collateralisation - 25% CC - 5%	AAA	AA+	Loans given for personal vehicle and commercial vehicle loans	Conditional Sale of pool to SPV	No
Vivriti Capital	75	CC - 3%	AA+ (CE)	A-			No
Muthoot Fincorp Limited	200	-	AA+	A+	Gold Loans	Upfront sale of pool to SPV	-
Muthoot Fincorp Limited	100	Over-collateralisation - 20% CC - 3%	AA+	A+	Gold Loans	Upfront sale of pool to SPV	Yes
Dhanvarsha Finvest Limited	15	Over-collateralisation-25% CC - 7%	A	BBB	Gold Loans	Upfront sale of pool to SPV	Yes
Ugro Capital Limited	20	OC - 30%	AA+	A	Mixed assets	Upfront sale of pool to SPV	Yes
Kanakadurga Finance Limited	10	OC - 12% CC - 5%	A	BBB-	Gold Loans	Upfront sale of pool to SPV	Yes

Regulatory Scenario

Despite the absence of a well-defined regulatory framework for issuance of covered bonds, they have gained traction in the Indian market and are expected to continue the trend. Attempts to introduce a regulatory framework for covered bonds in India have been made by regulatory authorities such as the National Housing Bank (NHB) and Securities and Exchange Board of India (SEBI).

- The NHB had constituted a Working Group on Securitisation and Covered Bonds in the Indian Housing Finance Sector. The report of the said group[7] suggested some structures that could work in the Indian market and evaluated issuances of covered bonds under general laws, through NHB intermediation and through a specific legislation for covered bonds.
  - Under the NHB intermediated structured, it was proposed that the NHB may ensuring repayment to the covered bondholders from the cover pool instead of the SPV.
- The SEBI's Corporate Bonds and Securitisation Advisory Committee (CoBoSAC) also had a separate agenda item on covered bonds. In the financial year 2013-14, the committee deliberated several times on covered bonds.

Besides the above, the Asian Development Bank (ADB) also tried to put forth their analysis and recommendations for a structure or framework for covered bonds in India.

Despite several efforts by various organisations and entities, a regulatory framework for covered bonds did not develop. Indian issuers have now started issuing covered bonds based on general law principles.

Further, along with the issuances of covered bonds in India, rating agencies were required to issue ratings to the covered bonds. The rating agencies (CRISIL[8] and ICRA[9]) accordingly issued rating methodologies for rating of covered bonds.

Our resources can be accessed here:

1. Covered Bonds in India: creating a desi version of a European dish
2. Introduction to Covered Bonds
3. Presentation on Introduction to Covered Bonds
4. The Name is Bond. Covered Bond

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[7] https://www.nhb.org.in/Whats_new/NHB%20Covered%20Bond%20Report.pdf

[8] https://www.crisil.com/mnt/winshare/Ratings/SectorMethodology/MethodologyDocs/criteria/crisils%20criteria%20for%20rating%20covered%20bonds.pdf

[9] https://www.icra.in/Rating/ShowMethodologyReport/?id=709

Annexure II – 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.

INDIAN SECURITISATION FOUNDATION
(A Not-For-Profit Company Licensed under Section 25 of Companies Act, 1956)
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Mumbai – 400 001, India, **Phone:** 022 – 2261 4021/ 022 – 6237 0959
Website: www.indiansecuritisation.com
Email: info@indiansecuritisation.com; vinod@vinodkothari.com

Advisory Committee

Mr. M.R Umarji	Mr. Madhukar R Umarji, Former Chief Advisor - Legal of the Indian Banks' Association is acknowledged as an authority on Secured Transactions Law in India. He began his career as a Legal Assistant for the state government simultaneously pursuing his Masters in law. Following his Masters, he shifted to being a Legal Advisor in commercial banks and completed his transition to a commercial banker by becoming Executive Director of a public sector bank. Later he was taken on deputation at Reserve Bank of India as Executive Director in charge of Department of Non-Banking Supervision. He has been a part of several Expert Committees set up by the Government and Working Groups concerned with Banking Sector Reforms in India. His pivotal role in the drafting of secured transactions legislation in India shaped the way for a path-breaking reform for the Indian banking industry.
Mr. D.K. Vyas	Mr. D K Vyas, MD and CEO, Srei Equipment Finance Limited, demonstrates a judicious balance between growth and prudence in lending. He is a B.Com graduate from the Ajmer University. Being a strategist, Mr. Vyas is known for his innovative ideas which have reshaped India's infrastructure equipment financing industry.
Mr. Sanjay Chamria	Mr. Chamria founded Magma (Now part of Poonawalla group) in 1988, along with Mr. Mayank Poddar. As the Executive Vice Chairman, he anchors policy formation, strategy planning and execution. He was born and educated in Kolkata, and graduated as one of the country's youngest chartered accountants in 1985 with national ranking. For the past 23 years, he has steered the organization from a three-employee, one-office set up to a company with 225+ branch offices and more than 6000 employees Mr. Chamria uses his position as one of the foremost leaders in India's asset financing industry to articulate his views on critical issues facing the industry and its future. He has represented the BFSI and NBFC industry at various forums, including RBI, and before the finance ministry and other government bodies. He has also chaired committees at the FICCI, the Hire Purchase & Lease Association of India, the CII, the Finance Industry Development Council (FIDC) and the Indian Merchants Chamber in Mumbai.
Mr. V. S Rangan	Mr. V. Srinivasa Rangan is Executive Director at Housing Development Finance Corporation Limited (HDFC Ltd). He has been associated with the company since 1986. Mr. Rangan is a Graduate in Commerce, CWA and an Associate member of the Institute of Chartered Accountants of India with national ranking.

Mr. Rangan has worked on international consulting assignments in housing finance in countries such as Ghana and the Maldives. He has also been a member of various committees constituted by the regulators in the areas of development of Mortgage Backed Securitisation and Secondary Mortgage Markets which includes RBI's Committee on Asset Securitisation and Mortgage Backed Securitisation and Technical Group formed by National Housing Bank for setting up of a Secondary Mortgage market institution in India.

Mr. Rangan was also conferred the "Best CFO in the Financial Sector for 2010" by "The Institute of Chartered Accountants of India" (ICAI) for exceptional performance and achievements as CFO in the Financial Sector for the year 2010.

Mr. T.T Srinivasraghavan

Mr. T. T. Srinivasaraghavan is the Managing Director at Sundaram Finance Ltd. He served as Joint Managing Director of Sundaram Finance Ltd.

Mr. Srinivasaraghavan also serves as Chairman of Infreight Logistics Solutions Ltd. He serves as an Executive Director of Sundaram Finance Ltd, and Director of Sundaram BNP Paribas Home Finance Limited and Sundaram BNP Paribas Asset Management Co. Ltd.

Mr. Srinivasaraghavan has a vast experience in the Banking and Finance sectors. He serves as President of International Finance & Leasing Association, United Kingdom. Mr. Srinivasaraghavan holds an M.B.A. in Finance Degree.

Directors

Mr. Vinod Kothari

Mr. Vinod Kothari is a noted scholar on securitisation and has lectured all over the World on securitisation. Vinod Kothari has been consulted by regulators in various countries, and has structured transactions in several markets. Vinod Kothari is the author of several books on the subject including Securitisation: Financial Instruments of Future, and Introduction to Securitization, (co-author with Frank Fabozzi), Credit Derivatives and Structured Credit Trading, etc.

For detailed profile of Mr. Vinod Kothari, see: http://vinodkothari.com/profile/

Ms. Vinita Nair Dedhia

Ms. Vinita Nair Dedhia holds a degree in Bachelor of Management Studies (BMS) from Sydenham College of Commerce and Economics, Mumbai University, Maharashtra, MS(Finance) from ICFAI university and is a Fellow Member of the

Institute of Company Secretaries of India (ICSI). She is a Senior Partner in M/s Vinod Kothari & Company, Practising Company Secretaries.

In 2020, she was one of the awardee of 'Best Secretarial Audit Report' Award at the ICSI National Awards for Corporate Governance, 2019 for the secretarial audit carried out for HDFC Ltd.

She has co-authored several books including Law & Practice relating to Corporate Bonds and Debentures published by Taxmann Publications, Companies Act viz. Your queries on Companies Act, 2013 and The Companies (Amendment) Bill, 2017.

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