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Securitisation of standard assets and receivables financings in India

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Introduction

As governments across parts of the world (including Europe and the United Kingdom) seek to tame inflation by raising interest rates and further with supply chain disruptions due to macro-economic factors, corporates have been looking to asset based / receivables financing and securitisation for working capital solutions. This article looks at: (i) the history and development of securitisation / asset based / receivables financing in India, (ii) the specific regulatory regime for securitisation in India, (iii) legal concerns where a seller of receivables may be based in India, and (iv) the risks associated with the insolvency of the SPV and the originator including in its capacity as servicer/collection agent.

History and development of the Indian market

Until 2006, India did not have any specific regulations governing securitisation of standard, performing assets. In 2006, the Reserve Bank of India (***RBI***) released guidelines on securitisation of standard assets by banks, all India term-lending and refinancing institutions and non-banking financial institutions (***NBFCs***) (the ***2006 Guidelines***). As per the 2006 Guidelines, securitisation was defined as a process by which certain assets were sold to a special purpose vehicle (***SPV***) for immediate cash flow. The cash flow could then be used to service the securities issued by the SPV. However, direct assignment of assets was not dealt with under the 2006 Guidelines. Even after the introduction of the 2006 Guidelines, securitisation transactions were

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rather uncommon in India mainly due to unfavourable tax laws governing the SPVs set up for securitisation transactions.

The Guidelines were amended in 2012 in order to develop a stronger securitisation market and enable not only securitisation of assets which was covered earlier but also provide for transfer of standard assets through direct assignment of cash flows. The applicable tax laws were also modified to enable the tax pass-through status of SPVs set up as securitisation trusts[1]. These amendments revived securitisation transactions in India.

In 2018, Infrastructure Leasing & Financial Services Limited (***IL&FS***), a large Indian Non-Banking Financial Company (***NBFC***) defaulted on its debt obligations. As a result, Indian NBFCs suffered a huge liquidity crisis and started showing a keen interest in securitising their standard assets to finance their funding requirements. As a result, India witnessed a sudden spurt of securitisation transactions.

In 2019, close on the heels of the IL&FS default, housing finance company Dewan Housing Finance Limited (***DHFL***) failed to make interest payments to its bond holders. DHFL had assigned some of its standard assets to financial institutions and continued to collect the receivables in respect of such assigned assets as a servicing agent on behalf of the assignees. On DHFL's default in payments to its bond holders, DHFL's creditors obtained a stay from the Bombay High Court on making payments to any of its creditors including receivables in respect of assigned assets[2]. This order raised concerns about the true bankruptcy remoteness of securitisations in India. Subsequently, the Bombay High Court clarified that the stay would not apply in respect of assets assigned by DHFL, thereby reinforcing the principle of bankruptcy remoteness of assets assigned pursuant to securitisation transactions[3].

Regulatory framework

On 24 September 2021, the RBI (Securitisation of Standard Assets) Directions, 2021 (***Master Directions***) were released. The Master Directions repealed all earlier RBI guidelines on securitisation of standard assets. The Master Directions were a result of the 'Draft Framework for Securitisation of Standard Assets' released by the RBI in 2020, which took into account the recommendations of the Committee on Development Housing Finance Securitisation Market in India and the task force on Development of Secondary Market for Corporate Loans, set up by the RBI in 2019.

[1] Section 11 (5TCA) of the Indian Income Tax Act, 1961
[2] Order of the Bombay High Court in Reliance Nippon Life Asset Management Ltd. vs Dewan Housing Finance Corporation Ltd. and Others dated 10 October 2019
[3] Order of the Bombay High Court in Reliance Nippon Life Asset Management Ltd. vs Dewan Housing Finance Corporation Ltd. and Others dated 13 November 2019

The key features of the Master Directions are as follows:

(a) a single asset securitisation is now permitted. This was not permitted under the 2012 guidelines;

(b) the minimum retention rate for the assets being securitised was revised to 5% of the book value of the assets being securitised for assets with original maturity of 24 months or less and 10% of the book value of the assets being securitised for assets with original maturity of more than 24 months;

(c) overcollateralization is no longer considered a form of minimum retention rate;

(d) a minimum investment threshold has been set out for securitisation notes, being ₹ 10 million;

(e) In the event securitisation notes are offered to more than 50 persons, they are required to be listed as per applicable regulations;

(f) holders of the securitisation notes may pledge or trade their holding without any restrictions;

(g) the assets purchased from other lenders can now be securitised as well with the inclusion of securitisation of the trade receivables; and

(h) the time gap between the securitisation of the assets and the issue of the securitisation notes should not be more than 30 days.

Recent amendments to the Master Directions

In December 2022, the RBI amended the Master Directions. Amongst other amendments, a new eligibility requirement was added, stating that loans with a maturity of less than 365 days could not be securitised.

The amendment also clarified that the minimum holding period for commercial and residential real estate mortgages should be counted from the date of full disbursement of the loan or registration of security interest with Central Registry of Securitisation Asset Reconstruction and Security Interest of India, whichever is later.

Cross-border securitisations originating in India

The most common route for cross border securitisations in India is through the foreign portfolio investor (***FPI***) route which is governed by the Securities and Exchange Board of India (***SEBI***). FPIs registered with SEBI are permitted to invest in:

(a) certificates or instruments issued by a special purpose vehicle (***SPV***) set up for securitisation of asset/s where banks, financial institutions or NBFCs are originators; or

(b) certificates / instruments which are listed in accordance with applicable SEBI guidelines.

The legal structure for such transactions is usually as follows:

(a) the Indian originator sells certain receivables to an Indian SPV which is usually set up as a trust for tax purposes (it can also be set up as a company or a LLP although this is very rare);

(b) the SPV in turn issues pass through certificates (***PTCs***) to offshore FPI investors on a private placement basis;

(c) the originator may make available credit enhancement (see paragraph (d) below) and may also undertake servicing obligations (on an arm's length basis) on behalf of the SPV; and

(d) credit enhancement may be structured as cash collateral placed in fixed deposits with a bank. Credit enhancement may also be in the form of excess interest spread (EIS), over-collateralisation or a first loss default guarantee.

The exposure of the offshore FPI investors is on the SPV which is usually managed by a corporate trustee if the SPV is set up as a trust and not on the Indian originator (other than for any credit enhancement provided by the originator). The trustee acts on the instructions of the investors based on the threshold voting percentage agreed in the definitive documents governing the transaction.

Having the above structure in place enables an easier process in terms of enforcement against Indian obligors, since the SPV and/or the originator if acting as the servicer/collection agent would be the party that would take any action for enforcement in India on behalf of the PTC holders. This would negate the requirement for the PTC holders themselves to have to carry out enforcement proceedings. Once again, the terms and conditions for enforcement would be covered in detail in the definitive documents governing the transaction.

Insolvency

In order to ensure that SPVs in a securitisation transaction are insolvency remote, if the SPV is set up as a trust, the trust deed for settlement of the trust contains provisions to ensure that the SPV is an independent entity separate from the originator and to ensure the "true sale" nature of the securitisation transaction. Therefore, the assets held by the trustee will not form part of the insolvency proceedings of the originator.

The ability to achieve bankruptcy remoteness through contractual means has also strengthened over the years. Courts in India give effect to limited recourse clauses if contractually agreed. Although, this has not been tested by Courts in India specifically in relation to securitization transactions, the view is that if the recourse is limited, the Indian Courts may uphold this sort of arrangement.

As far as the insolvency of the originator acting as a servicer or collection agent is concerned, the Indian Government introduced the Insolvency and Bankruptcy

(Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules, 2019 (***FSP Rules***) which provides for the protection of the rights of third parties with respect to assigned assets in the insolvency of notified finance service providers (***FSPs***) in India[4]. FSPs acting in the capacity of servicer or collection agent are beyond the reach of creditors in the insolvency proceedings of the FSP. As per the FSP Rules, a corporate insolvency resolution process (***CIRP***) may be triggered by an application made by the appropriate financial regulator (in this case the RBI) which will be dealt with in the same manner as an application filed by a financial creditor under the Insolvency and Bankruptcy Code, 2016. An interim moratorium commences for FSPs from the date of filing of the application till its admission or rejection. However, the moratorium does not apply to any third-party assets including any funds, securities and other assets required to be held in trust by the FSP for the benefit of third parties.

Conclusion

The regulatory changes with respect to securitisation in India over the last few years reflect the fact that the Indian government wishes to boost the securitisation market in India. Securitisation volumes in India have topped INR 1.15 trillion in the first nine months of 2023 which represents a 42% year-on-year increase according to rating agency CRISIL[5]. Small finance banks have been seen as the new originators in this space as they increased their securitised issuances since they view this as a route to access incremental liquidity[5]. In relation to securitisations of assets other than mortgage loans, commercial vehicles have traditionally dominated, but now microfinance loans have also seen a notable increase in securitisation transactions. Earlier this year, India saw a large domestic transaction involving securitisation of trade receivables from invoice discounting by fintech platform CredAble in collaboration with Northern Arc Capital. This was a first of its kind in India paving the way for many such other structured securitisation transactions. The securitisation market in India continues to see growth and is evolving quickly. An increase in liquidity especially in times of crisis is a sweet spot for originators while for investors, securitisations provide an attractive investment without the need to set up complex and expensive client-facing infrastructure.

[4] NBFCs (including housing finance companies) with an asset size of INR 500 crore (5 billion) or more, as per the last audited balance sheet have been notified as FSPs.
[5] Source: Business Insider India - https://www.businessinsider.in/finance/news/securitisation-volume-in-india-jumps-42-past-1-15-lakh-cr-mark-in-9mfy23-crisil/articleshow/97033426.cms