16th March 2020

To,
General Manager
Division of Policy & Inspection (CRA/DT)
Market Intermediaries Regulation and Supervision Department
Securities and Exchange Board of India
SEBI Bhavan, Plot No. C7, "G" Block, Bandra Kurla Complex
Bandra (East), Mumbai -400 051
Ph: 022-26441315

Sub: Suggestions on Consultation paper on Review of the Regulatory Framework for Corporate bonds and Debenture Trustees

Respected Sir/Ma'am,

About the Indian Securitisation Foundation (ISF)

ISF 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 securitization and fixed income securities in India.

Context

Securities and Exchange Board of India (SEBI) issued Consultation paper on Review of the Regulatory Framework for Corporate bonds and Debenture Trustees for public comments. In this regard, we have certain suggestions as set out in the annexure to this letter.

Should you need any further clarification, we would be glad to provide the same.

Thanking you,

Yours truly,

For Indian Securitisation Foundation

Sd/-
Abhirup Ghosh
Authorised Signatory

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Annexure: Comments/Suggestions on Consultation paper on Review of Regulatory Framework for Corporate bonds and Debenture Trustees

Name of the organization: Indian Securitisation Foundation			
Sr. No.	**Pertains to Point No.**	**Comments/Suggestions**	**Rationale**
1.	3.1	• Allow debentures to be secured in any manner, including the prevalent practice of enterprise-wide floating charge • Recognize Covered Bonds structure • Clarify on priorities of floating charges under IBC	Please refer Note 1
2.	3.2.1	Real-time monitoring of asset cover by DTs, by way of shared database which can also be used by auditors for certification.	Please refer Note 2
3.	3.2.2	Guidance for determining delinquency rate benchmarks may be prescribed.	
4.	3.3	Calling of Event of Default at ISIN level may require identification of assets at ISIN level.	Please refer Note 3
5.	3.4 & 3.5	• Debentureholders would be covered under ICA if these are entities mentioned in the RBI framework. • Allowing debentureholders to exit ICA may not go well with the benevolent idea of a collective resolution process. • Enforcement outside ICA, in case of pari-passu charges, will not be possible if debentureholders lack requisite majority under SARFAESI.	Please refer Note 4 and Note 5
6.	3.6	Along with the half-yearly asset cover certificate, a certificate stating the adequacy and maintenance of the recovery fund may also be obtained from the statutory auditor.	Please refer Note 6
7.	3.7 & 3.8	DT to be responsible to report on asset cover that the same has been independently and regularly assessed. Deteriorations to be taken up with the issuer for necessary rectification.	Please refer Note 7
8.	3.9	The concept of side letter may be completely done away with. The issuer to declare that there are no side letters, and all covenants are there in the IM only.	Please refer Note 8

NOTES

1. Securing the issue of debentures by 'identified charge'

The Consultation Paper seeks to derecognize floating charges and requires that debentures be called 'secured' only when charge is created on identified assets (receivables) of NBFC.

It may be noted that receivables are floating assets, and thus, it is not possible to create a static demarcated pool of receivables on which debentures can have a fixed charge. The pool of identified receivables will fluctuate on account of – (i) repayments, (ii) prepayments, and (iii) default. Given the very nature of the receivables, attempting to create fixed charge on such assets might be an impossible task[1]. Hence, the 'identified' charge, as the Consultation Paper calls it, will be nothing but a floating charge only, however, it would be different from an enterprise-wide floating charge. It would rather be a smaller sub-set of the latter.

One can discern that an entity can have an option of issuing debentures, as –

(i) unsecured,
(ii) secured by enterprise-wide floating charge,
(iv) secured by a charge on a demarcated pool of revolving assets, or
(iv) secured by fixed charge.

As per the proposal in the Consultation Paper, a debenture cannot be called secured in circumstances enumerated in (i) and (ii). However, we suggest that the issuers should be given the flexibility of taking a commercial call on whether at all the debentures be secured, and the manner in which the debentures shall

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[1] Reference may be drawn to *National Westminster Bank plc v Spectrum Plus Ltd and others [2005] UKHL 41* wherein the House of Lords held that a charge over book debts will be a fixed charge only if the proceeds of the debts have to be paid into an account over which the chargor has control. The account must be operated as a blocked account. Merely that the chargor has the right to prevent the chargee from drawing on the account without its consent is not sufficient. The *Spectrum* case builds up principles by which a charge on book debts can actually be called a fixed charge and not a floating charge.

Hence, it is very less probable for companies, especially NBFCs to practically implement the principles as mentioned above. Companies would not be willing to expose themselves to a regime where they block their receivables in favour of a secured creditor and seek approval for every withdrawal they make. As *Sir Goode* states *"for most practical purposes the fixed charge over book debts is dead". Source: 'The Case for Abolition of Floating Charges' by Sir Roy Goode, in the book titled Fundamental Concepts of Commercial Law.*

be secured, if so. The market forces shall be allowed to operate freely to decide on desirability of different instruments.

Research shows that the corporate bond market in India is primarily dominated by financial sector entities (issuer-side) with 76% of the market share, and balance 24% is captured by issuances by non-financial entities[2]. This implies that the asset-base available for creating a charge would prominently be in the form of receivables. Research also shows that globally and generally, debentures are unsecured - for instance, in 2019, a mere 5.83% of total bonds issued in the US were secured[3]. In fact, it is difficult to name a developed economy, where debentures are mandatorily required to be secured by way of a fixed charge. Also, floating charges are well recognised in jurisdictions across – for instance, see section 175, 176ZA and 176A of the UK Insolvency Act 1986. Floating charge is used to create an intermediate layer between fixed charge-holders and unsecured creditors. Hence, doing away completely with floating charges is not recommended.

Instead, in our view, the approach suggested by the Consultation Paper is akin to the concept of covered bonds, where there is a cover pool of assets (here, identified assets) monitored by a cover pool monitor (here, DT). Hence, it is suggested that the regulators may consider giving recognition to covered bonds[4].

Besides, an amendment might be required in the Insolvency and Bankruptcy Code, 2016 ('IBC'). At present, there is no distinction between fixed and floating charges in the priority waterfall under IBC. Due to lack of explicit provision, irrespective of the kind of charge, both the chargeholders are being treated as secured creditors. However, it is important to clarify that floating charges are always subservient to fixed charges, even if the charge gets crystallised on the happening of event of default. Note that the distinction between floating charges and fixed charged and the rule of seniority of fixed charges over floating charges is still preserved in section 327 of the Companies Act, 2013.

2. Due Diligence of identified assets and granular asset cover certificate [para 3.2]

It is imperative that the DTs follow a pro-active approach in constant monitoring of the asset cover – in terms of quantity and quality.

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[2] Source: Data collated from SEBI, CARE Ratings, etc.

[3] https://www.spglobal.com/en/research-insights/articles/u-s-corporate-debt-market-the-state-of-play-in-2019

[4] Please refer to our detailed note on covered bonds and required regulatory framework for the same: http://vinodkothari.com/wp-content/uploads/COBOSAC_presentation_on_covered_bonds_framework_in_India.pdf

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The pool may consist of thousands of receivables. In such scenarios, the half-yearly asset cover certificate by a statutory auditor, providing a list of all identified assets at a granular level, seems impractical. A 100 pager asset cover certificate is not what SEBI would be intending to obtain.

Our recommendation is that the issuer develops a shared database of receivables, wherein, the DT can monitor the variations in the pool, on a real time basis. The database would come with filter options such as underlying asset quality, LTV, asset performance, debenture series to which the asset has been charged, etc. The database would further highlight the changes in the assets over a defined/filtered time-span. This would enable quick review of substituted assets. Though such a requirement could lead to additional costs in the hand of the issuer, hence, the same can be implemented when the issuance size exceeds a certain threshold.

Similarly, the statutory auditor may do a detailed or sample checking of the pool from the same database and issue a certificate stating that the asset cover is adequately maintained.

Further, guidance for determination of delinquency benchmarking rate may be prescribed.

3. Calling EoD at ISIN level [para 3.3]

Where it is sought to identify default at ISIN level, we view that the pool of assets be identified at ISIN level only.

4. Ability to exit ICA [para 3.4]

The ICA framework applies to institutional entities[5]. Hence, the debentureholders would be a party to ICA only in case they fall in any of the categories mentioned in the RBI framework. In our view, ICA does not deal with the rights of individual/retail debentureholders, *per se*.

It may be noted that rights of debentureholder will depend on whether the charge created in their favour is 'exclusive' or is 'pari-passu' with other secured lenders. In case the charge is 'exclusive', it would be easier for the debentureholders to take enforcement call distinct from other secured creditors who would not be concerned about such assets. However, in case of pari-passu charge, it would be difficult to think of a situation where debentureholders are allowed to exit ICA and enforce the security, which is equally charged in favour of other secured creditors keen on resolution. As is also known, in case of joint financing of a secured asset, consent of a minimum of 60% (in value) of creditors is required under SARFAESI to initiate enforcement action. Therefore, the debentureholders may not be having a practical solution by exiting the ICA.

[5] RBI framework: https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11580&Mode=0

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Further, it is important to note that resolution of an entity is a collective process, and the process might entail collective compromises as well. If exceptions are carved out for any of the creditors, it is difficult to envisage success of ICAs, or any revival proceedings for that sake. Cram-down provisions are well recognized under law (including IBC) and should be respected. Individual actions against the company can erode the asset base of the entity. The idea of resolution over separate actions has been well advocated across Tribunals/Courts, including the Apex Court.

As to constitution of a committee, clarity is required as to composition of the same. Whether the same will be composed by debentureholders having majority across series/ISIN or series-wise/ISIN-wise should be laid in the regulations.

5. Voting by debentureholders [para 3.5]

Clarity is needed on how to establish the consent/approval of debentureholders, that is, whether the same shall be by way of ordinary or special majority. Notably, the implications of entering/exiting ICA or going for enforcement actions might be huge; as such, an ordinary resolution might not suffice.

6. Recovery fund [para 3.6]

The statutory auditor shall certify, besides the asset cover, that the recovery fund is being adequately maintained, and well demarcated from other general funds of the company.

7. Disclosures by and performance of DTs [para 3.7/3.8]

The DTs are expected to ensure that the asset cover with respect to debentures remain intact. We have proposed that the DTs should be allowed to have real time monitoring of the asset cover. The DTs should be mandated to report to the regulator at prescribed intervals that they have monitored the asset cover in the prescribed duration on real time basis, and have obtained auditor's certificate, and in their independent assessment, there is no deterioration in the asset cover, both in terms of value and quality. In case, they have observed any deterioration, the same should be disclosed, and reported; with steps taken to rectify the same.

8. Side letter [para 3.9]

Para 3.9 of the Consultation Paper states that all covenants given by way of side letter or otherwise shall be incorporated in the IM. Further, para 3.11 states that the IM should specifically disclose that the issuer has no side letter with any bond holder except the one(s) disclosed in the IM.

A side letter, conceptually, is a set of covenants or a collective bargaining agreement, which does not form part of the primary agreement. However, it is recommended that instead of allowing side letter to be a part of the IM, the concept of side letter should be discouraged totally. All covenants should be there in the IM only, and

there should be no side letter at all. The issuer shall undertake in the IM that he has not signed any side letter and that all covenants as included in the IM are the only covenants agreed to by the issuer.

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