INDIAN SECURITISATION FOUNDATION

Date: 26.06.2024

Smt. Usha Janakiraman
Chief General Manager-in-Charge
Department of Regulations
Reserve Bank of India

Sub: Representation for regulatory amendments to promote securitisation in India

Dear Ma'am,

On behalf of the Indian Securitisation Foundation (ISF), a not-for-profit entity representing the securitisation industry in India, we hereby submit our representation for regulatory amendments/ clarifications to promote the securitisation market in India.

ISF was incorporated with the objective of promoting and representing the industry to government, regulators, the public, investors and others who have an interest or potential interest, both, in India and overseas, regarding the benefits of securitisation in India and aspects of the securitisation industry. Our members include banks, NBFCs, microfinance institutions. A detailed profile of ISF forms a part of the enclosures as **Annexure II**.

On behalf of the ISF, we have assimilated the suggestions from the market participants and hereby submit our representation for your kind consideration. Our representation on the matter has been enclosed with this letter as **Annexure I**.

Should you need any further clarification, we would be glad to provide the same. In case there is a discussion required on the matter, we will be happy to come down to your office. Kindly look into the matter and oblige.

For **Indian Securitisation Foundation**

VINITA VENUGOPAL NAIR
Digitally signed by VINITA VENUGOPAL NAIR
Date: 2024.06.26 14:36:53 +05'30'

Vinita Nair
Director
DIN: 08067063

Cc: Ms. Surbhi Jain
Joint Secretary (FM)
Department of Economic Affairs
Ministry of Finance

Annexure I: Representation

The Indian securitisation market has come a long way - from being in the confines of the priority sector loan transfers, it is now actively being pursued as an investment product. A very notable development is the advent of non-financial sector securitisations, where small-ticket investors are being drawn in securitised debt instruments. Some distinguishing features of the Indian Securitisation Market are:

a. What is captured as "securitisation" by all concerned includes a substantial chunk of bilateral transactions on "direct assignments".
b. Residential mortgage-backed transactions form a very small proportion of the market, compared to other countries.
c. Traditionally, one of the prime motives for securitisation has been priority-sector loan pools, acquired by banks to fill their shortfall of the required priority sector exposure.
d. Banks are not active originators of the securitisation deals; they are mostly on the investment side.
e. The market for lower-rated tranches is only now developing; hence, most transactions have only one senior tranche.

Currently, the Indian securitisation market faces certain disparities that, in our view, do not align with the broader objectives of securitisation. These restrictions may be hindering the market from reaching its full potential. We believe that implementing the following recommendations will advance the securitisation market in India, encouraging diversified investor participation and fostering the issuance of further securitisation transactions.

The following are some recommendations to further promote the Indian securitisation market:

1. Assets eligible under Securitisation should include loans with residual maturity of less than 365 days

a. Issue Statement

Para 6 (d) of the Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021 ('SSA Directions') provides the following exclusion:

> *6. Lenders, including overseas branches of Indian banks, **shall not undertake** the securitisation activities or assume securitisation exposures as mentioned below:*
> *a. XX*
> *b. XX*
> *c. XX*

d. Securitisation with the following assets as underlying:

XX

vi. Loans with residual maturity of less than 365 days;

Accordingly, loans having *residual maturity* of less than one year are not eligible for securitisation under the SSA Directions.

b. Impact of the Issue

This amendment was done by the RBI vide amendment dated December 05, 2022. We are not aware of any consultation that preceded this change. The objective of restricting the securitisation of loans with maturities of less than 365 days might have been to indirectly restrict the issuance of short-term securitised papers in the market, as these are usually treated as money market instruments.

If that is the objective, then ideally the restriction should have been on the tenure of the securitised paper and not the remaining maturity of the securitised assets. It is common practice to securitise short term assets with the help of revolving or replenishment structures. Through these structures, short term assets are converted into long term papers. Para 5(n) of the Directions covers such revolving structures.

As a result of the change, following categories of assets of have been rendered ineligible for securitisation:

a. Loans having a residual maturity of 1 year;
b. Loans having an original maturity of 15 months or less (considering the MHP requirement);

The aforesaid exclusion under the SSA Directions has discouraged the securitisation of microfinance loans, fintech loans, and other short-term loans. Even gold loans also have a term upto 1 year. Fintech lenders and other lenders who extend short-term loans with a maturity varying from 3 to 12 months, look at securitisation as the potential avenue to raise capital market funding. Notably, the performance of short-term consumer loans has been quite positive, often surpassing that of long-term loans.

RBI report on Dynamics of Credit Growth in the Retail Segment: Risk and Stability Concerns dated Jan 18, 2024 notes:

> *As of June 2023, personal loans constituted the single largest category of bank credit, accounting for 49 per cent of total borrower accounts, and 30 per cent of the outstanding non-food credit.*

Therefore, the volume of personal loans is significant. Restricting securitisation of loans with residual maturity of 365 days or more does not seem to serve the regulators intent of maintaining sufficient liquidity among lenders to undertake fresh exposures via tapping into the capital markets.

Notably, there is no bar on bilateral transfer of such loans to other regulated lenders, via a "transfer of loan exposures" (TLE). However, TLE is not something which policy-makers would want to promote as an alternative to securitisation. TLE results in movement of loans within regulated financial entities, whereas securitisation takes the exposures to the capital markets. Therefore, any regulation that forces stakeholders out of securitisation, and opt for the TLE route, needs to be re-examined.

c. Proposed change

The restriction on securitising assets with a residual maturity of less than 365 days should be removed. The Directions may provide for assets with a residual maturity of less than 365 days to be securitised only through a replenishing structure. Alternatively, the restriction may be imposed on the tenor of the securitised paper.

d. Impact of the proposed change

The removal of the aforesaid restriction on securitisation of loans with less than 1 year residual maturity will facilitate the securitisation of short-term loans as well as revolving structure securitisation. Furthermore, this change would also align with the broader object of securitisation as provided under the SSA Direction, i.e, towards facilitating a well-functioning financial market, building of a bridge between financial markets and capital markets, improving risk distribution and risk diffusion by integrating capital markets with asset markets.

e. Modality and relevant authority:

May be done by appropriate amendment of the SSA Directions by RBI. No statutory change required.

2. Carve out for banks/regulated lenders for investment in Securitised Debt Instruments (SDIs)

a. Issue Statement

Para 80 of the SSA Directions states that,

> *"80. All securitisation exposures,* ***which are not covered by these directions****, or which do not satisfy the conditions prescribed in these directions (including the exposures prohibited as per Clause 6), or where originator is not a lender referred to in Clause 3, or for which prudential treatment is not advised explicitly in these directions,* ***lenders shall keep capital charge equal to the actual exposure and will be subjected to supervisory scrutiny and suitable action****."*

The intent behind this provision might have been to discourage banks/NBFCs to invest in transactions which are happening beyond the regulatory framework.

As it stands, there may be two modes of regulated securitisation transactions:

- Done by financial sector entities (banks, NBFCs) under the SSA Directions of the RBI
- Done by financial or non-financial sector entities, but mostly non-financial sector entities (such as future cashflows securitisation) under the SEBI (Issue and Listing of Securitised Debt Instruments and Security Receipts) Regulations, 2008 ('SDI Regulations')

Both of these are regulated issuances. The latter is listed with the stock exchanges.

However, the language of para 80 does not acknowledge transactions being done under the SDI Regulations.

As a result, investment in SDIs is not covered under the SSA Directions and is not recognised as a permissible instrument for banks or regulated lenders under these guidelines. Consequently, according to the aforementioned provisions, banks and regulated lenders are required to maintain a full capital charge on their actual exposure when investing in SDIs issued by non-regulated entities.

b. Impact of the Issue

Maintaining a full capital charge against the exposure in SDI instruments virtually shuts the opportunity for any bank or NBFC to invest in securitisation of future cashflows.

This stringent requirement ties up a significant amount of capital, reducing the bank's/regulated lender's ability to allocate funds to other potentially profitable and essential activities.

Note that there is a growing opportunity for securitisation of non-financial sector cashflows. This includes infrastructure cashflows, various other stabilized cashflows sources such as royalties, tuition fees, property rentals, equipment rentals, lease receivables, etc.

The inherent dichotomy is that the very bank/NBFC may be a lender to the very same business, which securitises the receivables. However, the moment the bank/NBFC invests in securitised notes emerging from such cashflows, there is 100% capital charge.

Obviously, this could not have been the idea of the regulator.

c. Proposed change

The requirement to keep capital charge equal to actual exposure should entail a carve-out for banks/regulated lenders undertaking investments in transactions done in pursuance of SDI Regulations.

The transactions securitised under SDI Regulations are governed by the regulations issued by a parallel regulator SEBI and are usually listed. There is no reason to hit banks/regulated lenders with a full capital charge in such cases.

d. Impact of the proposed change

Banks/regulated lenders would be incentivized to invest in SDIs since they would no longer face a full capital charge on these exposures. Note that the country sees a huge opportunity for monetisation of assets and cashflows. The country also has a variety of operational cashflows from business such as telecom, IT, licensing, royalties, etc. These structures, done by non-financial sector entities, are obviously done outside of SSA Directions. The bar on banks to invest in such transactions is stifling any such monetisation possibility.

e. Modality and relevant authority:

May be done by appropriate amendment of the SSA Directions by RBI. No statutory change is required.

3. Reduction in TDS Rates

a. Issue Statement

Section 194LBC of the Income Tax Act, 1961 reads as follows:

> *"Where any income is payable to an investor, being a resident, in respect of an investment in a securitisation trust specified in clause (d) of the Explanation occurring after section 115TCA, the person responsible for making the payment shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon, at the rate of—*
> *(i) twenty-five per cent, if the payee is an individual or a Hindu undivided family;*
> *(ii) thirty per cent, if the payee is any other person."*

The rates for tax deduction at source (TDS) originated from the replacement of the distribution tax with TDS. Given the significant evolution of the market since then, there is no justification for maintaining withholding tax rates at such high rates.

As per the Finance Bill 2024, TDS applicable in case of interest income from bonds under section 193 is 10%.

Therefore, the TDS rates provided under section 194LBC are even higher than those applicable to bonds.

b. Impact of the Issue

Return on Investment is one of the major motivations for investing in an instrument. Such high rates of TDS prove to be discouraging to investors for investing in securitisation notes resulting in low investments and withholding growth of the securitisation industry.

c. Proposed change

The TDS rates should be reduced and brought at par with the witholding tax rates applicable to bonds.

d. Impact of the proposed change

Reduction in TDS at the time of credit of income would result in investors retaining a larger portion of their investment returns upfront, thereby increasing their overall yield in their investments. Such improved income retention will benefit investors as well as potentially attract more investment due to such enhanced returns.

Moreover, a reduction in TDS will make securitized notes more competitive compared to other investment options contributing to economic growth.

There is no chance of any tax leakage by the income moving out of the tax system, as all the investments are necessarily through demat mode, and all the investors are recognised tax payers.

e. Modality and relevant authority:

Requires amendment in the Income Tax Act.

4. Permissibility for carrying out factoring activities by all NBFCs

a. Issue Statement

Para 3(1) of the Factoring Regulation Act, 2011 ('Factoring Act') states that,

> *"No factor shall commence or carry on the factoring business unless it obtains a certificate of registration from the Reserve Bank to commence or carry on the factoring business under this Act."*

Further, in terms of the Registration of Factors (Reserve Bank) Regulations, 2022, existing NBFC-ICC, intending to undertake factoring business, are required to make an application to the Reserve Bank for the grant of CoR under the Factoring Act if it satisfies the prescribed eligibility criteria, as follows:

> *"(a) not accepting or holding public deposits;*
> *(b) total assets of ₹1,000 crore and above, as per the last audited balance sheet;*

(c) meeting the NOF requirement as prescribed in regulation 3 of these regulations;
(d) regulatory compliance."

Accordingly, only entities registered as factors and NBFC-ICC after obtaining a certificate of registration are permitted to carry out factoring business.

The only admitted intent of the Factoring law was to promote trade finance; however, the narrow window of factoring business, coupled with the bar on a non-factor from engaging in factoring, even on a non-principal activity basis, has curbed factoring to a great extent. Sadly, this is coming at a time when trade channel finance, and moving of working capital finance outside traditional modes of working capital financiers, is gaining popularity both in India and globally.

b. Impact of the Issue

The aforesaid regulatory mandate has restricted the conduct of factoring to only a special category of companies registered as factors or permitted as such. As per our knowledge, there are a handful of specialised factoring companies, or NBFCs registered for factoring business.

This limitation hampers the growth and accessibility of trade finance. Factoring is a critical tool for businesses, especially small and medium enterprises (SMEs), as it provides immediate liquidity and helps manage cash flow by selling their receivables. Accordingly, by allowing only registered factors or specific licensed entities to engage in factoring, the law inadvertently creates an entry barrier for other NBFCs that could otherwise participate in the market and contribute to its expansion.

Note that the access to TREDS platform is also restricted to entities registered as factors.

Since NBFCs in general cannot do factoring at all, they cannot build trade finance pools for securitisation.

c. Proposed Change

Considering that the primary intention of the Factoring Act was to promote trade financing, factoring should be permitted for all RBI-regulated NBFCs. This change would involve amending the current regulations to allow any NBFC that meets certain predefined criteria to engage in factoring activities without needing a separate license or registration as a factor.

d. Impact of the proposed change

Allowing all NBFCs to engage in factoring would significantly enhance the accessibility and growth of trade finance. This change would provide businesses, particularly SMEs with greater access to

immediate liquidity by allowing them to sell their receivables more easily. Increased participation from a broader range of entities would foster a more competitive market, potentially leading to better terms of obtaining finance and businesses.

Moreover, expanding the pool of entities permitted to offer factoring will serve the primary intention of the Factoring Act which was to promote trade financing. The change will contribute to a more vibrant and dynamic financial market, which will improve cash movement for businesses and support overall economic growth.

e. Modality and relevant authority:

May be done by appropriate amendment of Registration of Factors (Reserve Bank) Regulations, 2022. NBFCs of a particular asset size, say Rs 100 crores or above, may automatically be allowed to do factoring.

INDIAN SECURITISATION FOUNDATION

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:

a. **Advocacy** – making representation to various authorities from time to time on matters as may concern securitisation and similar capital market instruments.
b. **Industry forums and networking** - holding periodic conventions and educational courses.
c. **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.
d. **Information exchange** – on matters of common interest, collateral performance, etc.

Executive Committee

Executive functions of the ISF are currently being discharged by team of Vinod Kothari Consultants P. Ltd. The team is led by Mr. Vinod Kothari and Ms. Vinita Nair.

Mr. Vinod Kothari

Vinod Kothari is internationally recognized as an author, trainer and consultant on specialized financial subjects, viz., housing finance, securitisation, credit derivatives, accounting for financial instruments, structured finance, banking regulations etc. As such, he lectures all over the world. The locations where he has lectured on these subjects include New York, Washington, London, Milan, Frankfurt, Singapore, Hong Kong, Sydney, Colombia (South America), South Africa, Malaysia, Jordan, Dubai, Kuwait, Egypt, Sri Lanka, Bangladesh, etc.

Mr. Kothari with his efficient team has handled very diverse groups – from rating agency professionals in Malaysia, to group of investors in Sydney, to tax officers in South Africa, to group of lawyers in India, to executives of the World's largest securitisation agency in Washington, to a group of quants in New York. See full profile of Ms. Vinod Kothari here.

Ms. Vinita Nair

Ms. Vinita Nair is the Director of the Indian Securitisation Foundation. Her expertise lies in the field of Corporate Laws, Corporate Restructuring, Merger/Amalgamation and general corporate advisory matters, incorporation of companies including section 25 companies, FEMA matters and compliances. Vinita has also taken lectures on related topics. See full profile of Ms. Vinita Nair here.