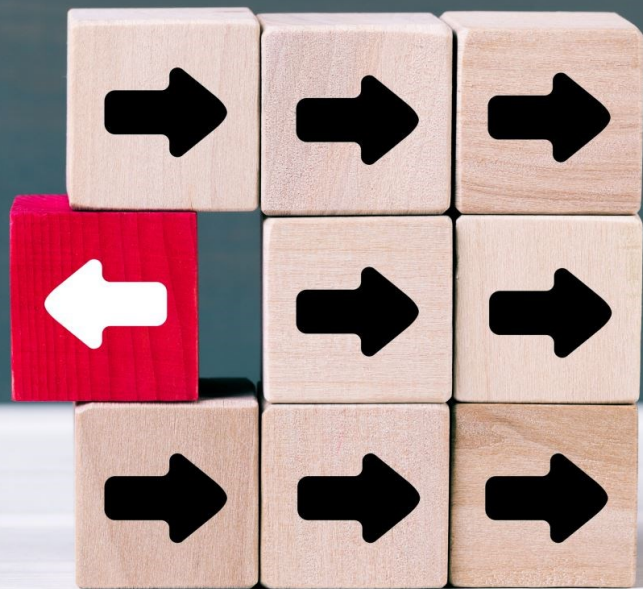




ECONOMIC
LAWS
PRACTICE
ADVOCATES & SOLICITORS



Securitisation of Stressed Assets Framework (SSAF): Discussion Paper of the Reserve Bank of India (RBI)

Securitisation of Stressed Assets Framework (SSAF): Discussion Paper of the Reserve Bank of India (RBI)

The Reserve Bank of India (RBI) has issued a discussion paper on Securitization of Stressed Assets Framework (SSAF) in India with a view to clear the way for SSAF. India's financial controller has been experimenting with options to deal with the issue of resolution and realization of Non-Performing Assets (NPAs, as they are known in India). However, for the first time, the new initiative looks beyond resolution and focuses on monetization of such NPAs.

How NPA Hurts the Banking Industry

NPA in the balance sheet of a bank/lender is a double edge weapon which hurts its holder in two ways. First, it blocks its capital and funds to that extent without any earnings. Secondly, it eats into its profits - as a portion of the profit of the lender needs to be set apart by way of provisioning for such NPAs. So, contrary to general perception that declaration of a borrower account hurts a borrower, declaration of such an account as NPA hurts a lender too though the consequences may differ for both. NPAs are also a challenge for lenders/banks for maintaining their capital adequacy ratio and profitability. It is for this reason that both the Regulator and the Government have been experimenting with different options to accelerate recovery from such NPAs. While the Insolvency and Bankruptcy Code, 2016 (the Code/IBC) was put in force in 2016 with an objective to facilitate resolution of insolvency and provide exit option to the industry, but so far it has primarily been used for recovery by Banks and other creditors. It has been a mixed bag so far - as haircut for creditors relative to the fair value of assets is around 16%, while relative to their admitted claims is around 69%. Out of 6199 Corporate Insolvency Processes initiated till December 2022 only 611 cases have ended in approval of resolution plans, while 1901 have ended in orders for liquidation¹. Additionally, delays at various levels are also a serious concern as it directly impacts realization for the stakeholders including lenders.

Overreliance and a dampened success of the regime under the Code has been due to many factors. One of them was that the regime under the Code was not backed by a support system to facilitate financing of acquisition of business through a resolution plan and interim financing norms. There is no loan market mechanism to support offloading of portfolios by banks and lenders. For a long time, even Assets Reconstruction Companies (ARCs) also struggled to take part in the corporate insolvency resolution process under the Code on account of lack of policy clearance from the RBI. Additionally, save for and except the arrangements provided in respect of NARCL², no system in the form of guarantee mechanism exists in India to support securitization of NPAs. The RBI has now proposed a framework on securitization of NPAs as part of additional measures³. SSAF system basically helps the Banks with more liquidity for lending and reduce their NPA portfolio.

Two Type of Systems for securitization of NPL

There are primarily two types of systems that are followed for SSAF. One of them is **Government-backed securitization** under which the government provides a guarantee to the senior tranche. The other system is **market Securitization transactions**. Government-backed schemes generally provide better pricing and therefore minimize potential losses for originating banks. Such schemes have already been implemented in Italy as (GACs) Garanzia Cartolarizzazione Sofferenza and in Greece as HAPS, Hellenic Asset Protection Scheme (HAPS).

Existing Mechanism

Presently India does not have a formal system for securitization of NPAs. The existing mechanism only provides for a direct assignment of such assets to ARCs who are required to hold a license from the RBI for operating in this arena and comply with stringent requirements for holding funds and capital. These ARCs in turn issue Security Receipts⁴ (SRs) which can only be held by a qualified buyer. As per RBI guidelines dated February 26, 2014, assets classified as SMA-2 are also permitted for sale to ARCs. SRs are to be rated by a SEBI approved rating agency every six months, based on which Qualified Buyers (QIBs) value their investment in SRs. Valuation is based on expected cash flows to be collected from the pool of NPAs underlying the SRs. Prudential accounting norms require that SRs held by the ARC which have not been redeemed within the maximum permitted timeframe of 8 years are to be treated as loss assets.

Regulatory and legal framework

These SRs are recognized as securities under Securities Contracts (Regulation) Act, 1956. SEBI has issued listing guidelines for the SRs vide Securities and Exchange Board of India (Public Offer and Listing of Securitised Debt Instruments) (Amendment) Regulations, 2018 dated June 26, 2018. However, despite availability of the listing framework, listing and consequent trading of SRs through the exchanges has not taken off.

Challenges

- The basic challenge comes from the very nature of such securities, being the SRs representing (already) impaired assets whose cash flow cannot be predicted.
- *Further, for all practical purposes, there is no secondary market for SRs. Data shows that the majority of outstanding SRs are either being held by selling lenders as sale consideration or by the ARCs themselves due to regulatory requirements⁵.*
- *Further, AIFs which have invested in the ARC cannot invest in SRs issued by the ARC.*
- *AIF cannot invest in the securities issued against loans of its associate or group companies.*
- *AIF cannot invest in SRs backed by non-performing assets of banks which hold equity of more than 10% in that AIF.*
- *FPIs were allowed to make 100% investment (subject to regulatory cap) in the SRs issued by ARCs vide notification dated October 27, 2016. However, there are taxation related issues which need to be resolved as FPIs might not be interested if the transaction is taxed at the AIF level at the maximum marginal rate, i.e., at an effective tax rate 42.74%.*

Provisioning Requirement for Investment in securities issued by Asset Reconstruction Companies (ARCs)⁶

- Investments in the Security Receipts (SRs) / Pass-Through Certificates (PTCs) issued by ARCs, in respect of the financial assets sold by banks to them, are recognized at the lower of the following until its sale or realization:
 - the redemption value of the SRs /PTCs, and
 - the Net Book Value (NBV) (i.e. Book value less provisions held), of the financial asset.
- The valuation, classification, and other norms applicable to investment in non-SLR instruments prescribed by the RBI are applicable to the bank's investment in debentures / bonds / security receipts / PTCs issued by ARC.

NPA Securitization

Loan accounts which are not serviced by the borrower or where there is default in repayment of interest or the principal, are categorized as NPAs, if the default continues for a period of ninety days or such other duration as may be laid down by the Regulator. A borrower account could also be declared as NPA on technical grounds such as delay in achieving date of commencement of commercial operations, restructuring etc. Securitization is a process whereby such NPAs or such portfolios are transferred to a separate entity (SPV) which in turn issue notes or Assets Backed Securities (ABS) in different form of tranches (senior, mezzanine and junior) which may carry a fixed or floating coupon rate. The bank transferring the NPAs is called Originator. Post securitization and SPV taking over the NPA, there could be flexibility with regards to the recovery process which may either be outsourced to a service provider or retained with the Originator. The Originator Bank/Service Provider may be required to retain a fixed percentage of SRs to ensure their involvement in realization risk.

The Basel standards define NPL securitization as a securitization where the ratio of the nominal amount of 'delinquent underlying exposures' to the nominal amount of underlying exposures (a ratio termed 'W') is equal to or higher than 90%. Regulators can use a stricter definition of NPL securitizations than the Basel standards, both with regard to the scope of eligible exposures and 'W'.

The concept of NPA Securitization brings a shift in approach to NPAs - from being treated as a dead asset to a tradable commodity - and brings in huge potential for lenders for unlocking the value in NPAs. However, the real challenge lies in the valuation of the SRs and the underlying assets. Different types of lending accounts (such as retail, housing loan, MSME loans, infra loans, commercial loans etc.) bring in varied values. Usually, NPAs are pooled in different types of buckets/pools. Pooling of NPAs largely determines its underlying value. Pooling based on a mixed bag concept could be an issue if retail loans are pooled with long tenure loans such as infra loans. This is since retail loans usually offer a better predictable return as compared to Infra or long terms loans which may even require additional funding and a long gestation or recovery period. Further, the type of funds (short term/long term) with the investor would also be a crucial factor for investment purposes. Therefore, a portfolio-based approach could be a better solution.

Risk Retention

Synthetic securitization is not permitted as regards standard assets, however, it will be an issue for SSAF as it would necessarily require transfer of risk of an underlying pool representing SRs. The system may also require initial support for development of market, therefore, there is a strong case for allowing the use of funded (credit-linked notes) or

unfunded (credit default swaps) and credit derivatives or guarantees to hedge the credit risk of the portfolio. Additionally, the portfolio could also include restructured assets to offer a better commercial value.

Based on European experience, it is seen that the guarantee backed scheme work more efficiently, therefore, the RBI could also engage with National Credit Guarantee Trustee Company Ltd (NCGTC) and the Government to work out a guarantee mechanism to develop the market. However, efforts should be made to ensure that guarantee is not limited to senior tranches. As, as experienced in Europe, transactions with government guarantee schemes are being favored which is creating distortion in transaction structures.⁷

Securitization standards under the Basel Framework

Basel Committee on Banking Supervision, noted that securitized portfolios mostly consist of non-performing loans which have potential risk weight miscalibration. Based on this, the Committee agreed to add the following elements to the securitization standards in the Basel Framework, to be implemented by no later than January 1, 2023⁸:

- An explicit definition of securitizations of non-performing loans.
- Removal of the option to use foundation internal risk-based parameters as inputs for the internal ratings-based approach (SEC-IRBA) for all securitizations of non-performing loans.
- Introduction of a 100% risk weight floor for exposure to securitizations of non-performing loans that are risk weighted under the SEC-IRBA or the standardized approach (SEC-SA).
- For the senior tranches of securitizations of non-performing loans where the non-refundable purchase price discount is equal to, or greater than, 50% of the securitized portfolio, the risk weight under SEC-IRBA or SEC-SA is 100%.
- All other provisions of the current securitization standards, including the use of external ratings-based approach (SEC-ERBA) and the possibility of capping the capital requirement for exposures from the same transaction, will also apply to securitizations of non-performing loans.⁹
- The underlying pool of exposures of an NPL securitization may only comprise loans, loan-equivalent financial instruments or tradable instruments used for the sole purpose of loan sub participation.
- NPL securitization may not be backed by exposures to other securitizations.
- Norms also require the Regulators to scrutinize NPL securitizations to prevent any instances of regulatory arbitrage.
- It also requires the Regulators to preclude transactions executed with the main purpose of reducing the capital charge on the non-delinquent exposures in the underlying relative to the 100% risk weight on the senior exposure to the NPL securitization (as referred to in CRE45.5).
- The risk weight applicable to exposures to NPL securitizations according to SEC-IRBA (CRE44), SEC-SA (CRE41) or the look-through approach in CRE40.50 is floored at 100%.
- Where, according to the hierarchy of approaches, the bank must use the SEC-IRBA or the SEC-SA, a bank may apply a risk weight of 100% to the senior tranche of an NPL securitization provided that the NPL securitization is a traditional securitization and the sum of the non-refundable purchase price discounts (NRPPD), calculated as (described in CRE45.6), is equal to or higher than 50% of the outstanding balance of the pool of exposures.
- Only initial sale from the originator to investors is taken into account in the determination of NRPPD. The purchase prices of subsequent re-sales are not considered.
- An originator or sponsor bank may apply the capital requirement cap to the aggregated capital requirement for its exposures to the same NPL securitization. The same applies to an investor bank, provided that it is using the SEC-IRBA for exposure to the NPL securitization.

The RBI may have to look into all such considerations as provisioning norms could be an issue if both NPA portfolio and the connected SR portfolios of the originator are to be provided for as per the capital adequacy norms.

Role of Arrangers/ Financial Advisors

It is seen that there is a practice in some jurisdictions where ‘financial advisor’, ‘arranger’ or ‘placement agent or manager’ who play a critical role in preparing and marketing the securitization transaction, also underwrite the

transaction. Advisors though basically play an advisory role for preparation of strategy on securitization and resolution and management of funds.

Role for Legal advisors will also be important in the structuring of the transactions, its operation and in the preparation of the legal documentation.

Taxation

Taxation would be another critical issue which would need to be addressed for SSAF to be effective. As regards SRs issued by ARCs, the RBI Committee proposed that all income from investment in SRs issued by ARC trusts earned by an AIF should also be considered as pass through and taxable in the hands of the investors of the AIF. The possibility of a 42.74% tax at the AIF level is a deterrent for this investment to flow into ARC trusts. Large pools of capital are required for large resolutions by ARCs. Hence a pass-through regime for AIF income from investment in SRs issued by an ARC Trust is critical to the success of a competitive market for these NPAs and for maximization of recovery for the ARC.¹⁰

Similar treatment needs to be considered for SSAF. The Committee has also suggested that it may be clarified that any upside arising as business income may be taxed at the rate of 20% (as it is in the nature of income of securities under Section 115AD of Income Tax Act). Given the risky nature of the investment in SRs as also the fact that significant amount of money is needed to resolve the NPAs in the Indian financial sector, it is essential that tax certainty is provided to foreign investors.

Other issues that need to be addressed by RBI

Beside the above regulatory and taxation issues, the RBI will also have to work out solution to address the following:

Amendment in SARFAESI Act and DRTBT Act & the Code	This would be needed to ensure that the service providers or the SPV is enabled to initiate/maintain legal action under the relevant legal provisions to recover NPAs.
SEBI AIF Regulations	To be effective, independent Regulations would be needed to address regulatory requirements for investment and trading in SSAF.
NCGTC /CGTMSE Guarantee	A special guaranteed mechanism could be worked out for NPAs under MSME portfolio so that Banks may have additional funds to lending to this sector.
SPV/Resolution Managers/Originator	The critical issue would be the responsibility to comply with prudential norms. Ideally, this obligation should move from the Originator to SPV. Contractual obligation or Regulatory Note, can bind the Originator to continue to ensure smooth sharing of information.
Minimum Risk Retention (MRR)/Synthetic Securitisation	Requirement of MMR with the Originator could hurt it - if both assets classification and investment classification norms - are applied under SSAF as it may hurt the Originator. If the purpose is to provide an option to the Banks/Lenders to deal with the NPAs, a flexibility would need to be provided in this regard by relaxing MMR norms and allowing Synthetic Securitisation of NPAs.
SSA and SSAF	Under the present regime, Standard assets would need to be excluded from the proposed framework as that would create issue on account of requirement of risk retention.
Resolution/ Recovery	Both the options should be made available for resolution of impaired assets under SSAF and SPVs would need to be provided liberty to maximise the value.
Valuation Norms	A transparent working module would need to be worked out and minimum parameters could be evolved by the rating agencies.

Additional Funding/ Provisions Norms	Funding norms for restructuring and consequential provisioning norms will also need to be worked out to ensure that transactions do not attract dual provisions for assets as well as investment under SSAF system.
Personal Guarantee/ Collateral Securities	While such risk mitigants in NPAs would influence value of the assets, the SPV would need to be enabled to resolve the personal guarantees and collateral securities as part and parcel of the deal under resolution.
Due Diligence	Different due diligence mechanisms may be needed depending upon the portfolio and status of the Borrower. Large projects could only be resolved by way of resolutions, therefore, valuation would be based on possibility of turnaround of operation and future cash flow whereas retails portfolio will be value based on average recovery and discounting factors.
Action by Operational Creditors under the IBC Code	This could be a big challenge for the SSAF and attracting investment. It therefore would need to be addressed.

There is an urgent need for the RBI to provide necessary support systems such as SSAF, Interim Financing, Loan Market /Secondary Market for trading of loans/NPAs/SRs/Notes, not only from the point of view of building in support mechanisms for resolution under the Code but also to enable the lenders/banks to monetize their NPA portfolios. This will also help in reducing sole reliance on the IBC mechanism to resolve NPAs , which would consequently ease the pressure on the Tribunals.

We trust you will find this an interesting read. For any queries or comments on this update, please feel free to contact us at insights@elp-in.com or write to our authors:

Mukesh Counsel, Senior Counsel – MukeshChand@elp-in.com

Disclaimer: The information contained in this document is intended for informational purposes only and does not constitute legal opinion or advice

¹ <https://ibbi.gov.in/uploads/publication/138597264c97f5fe167e1250e1e1e4bf.pdf>

² National Asset Reconstruction Company Limited (NARCL), and India Debt Resolution Company Limited (IDRCL) for aggregation and resolution of Non-Performing Assets (NPAs) in the banking industry. NARCL a government entity, has been incorporated on 7th July 2021 with majority stake held by Public Sector Banks and balance by Private Banks with Canara Bank being the Sponsor Bank. NARCL is registered with the Reserve Bank of India as an Asset Reconstruction Company under Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

³ <https://www.rbi.org.in/Scripts/PublicationsView.aspx?id=21728>

⁴ "Security receipts" are defined under section 2 (1) (zg) of SARFAESI Act as under: "security receipt" means a receipt or other security, issued by an asset reconstruction company to any qualified buyer pursuant to a scheme, evidencing the purchase or acquisition by the holder thereof, of an undivided right, title or interest in the financial asset involved in securitization."

⁵ <https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=1188>

⁶ RBI Master Direction - Classification, Valuation and Operation of Investment Portfolio of Commercial Banks (Directions), 2021 (Updated as on December 8, 2022)

⁷ <https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op292~092b778aa8.en.pdf>

⁸ <https://www.bis.org/bcbs/publ/d511.pdf>

⁹ <https://www.bis.org/bcbs/publ/d511.pdf>

¹⁰ <https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=1188>