# Viability and Effect of Securitisation on Banking Sector: A Comparative Analysis between India and USA

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## Abstract

The financial sector has been one of the key drivers in India's efforts to achieve success in rapidly developing its economy. While the banking industry in India is progressively complying with international prudential norms and accounting practices, there are certain areas in which the banking and financial sector does not have a level playing field as compared to other participants in the financial markets of the world. In order to boost the banking industry it is very necessary that proper recovery procedures should be formulated in this globalised era and those procedures should comply with international standards. Financial markets in the world today are replete with products which were relations at one time. Insurance risk has always been a relation- of providing and seeking protection. Today, this relation is tradable as a commodity. Aided by derivative devices, more such risks and relations are placed in capital markets today- signaling a broader trend- the trend of commoditisation, of securitisation. Securitisation of an asset is a subject on which there has been a lot research conducted and there are lot of issues related to the securitisation process which are very relevant. This research is limited to one such relevant issue in the securitisation market which has not yet received the required attention. This research traces the absence of good securitisation provisions in the Act for banks as well as financial institutions and highlights the need for having good securitisation provisions for banks and financial institutions to which most of the existing Securitisation Act provisions are not applicable. Due to time constraints the researcher were not able to discuss all the international aspects but have been restricted to some of the aspects followed in the U.S.A although it can be said that there still remains a wide scope for further research.

**KEYWORDS**- Securitisation, Capital Markets, Recovery Procedures

## Introduction

"*Just as the electronic industry was formed when vacuum tubes were replaced by transistors, and transistors were replaced by integrated circuits, the financial services industry is being transformed now so that the securitised credit is beginning to replace the traditional lending. Like other technological transformation, this one will take place over the years, not overnight. We estimate it will take place 10 to 15 years for structured securitised credit to replace displace completely the classical lending system not a long*

*time, considered that the fundamentals of banking have remained essentially unchanged since the middle age".*
---------Lowell Bryan

**Securitisation- the concept**

The financial segment of today's era has been one of the unique key drivers in India's efforts to achieve success in the fast developing economy. While the bankingsector of India is continuously consenting to the global prudential standards and bookkeeping hones, there are sure territories in which the saving money and monetary area do not have a level playing field when contrasted with different members in the budgetary markets on the planet. Dissimilar to the system of Uniform Commercial Code, the Indian banks and fiscal establishments do not have the ability to take responsibility for and offer them without the intercession of courts and tribunals. The presentlegally permissible structure of India for identification of the business trades has not kept pace with the changing business hone and budgetary region changes. This has realized moderate pace of recovery of defaulting credits and mounting levels of Non-performing Assets of banks and cash related foundations.

The money markets in today's worldare loaded with items which were relations at one time. Insurance risks have dependably been an issue of giving and looking for insurance. Today, this connection is tradable as an item. Facilitated by derivativedevices, all the more such dangers and relations are put in the capital markets today, flagging which is a more extensive pattern of commoditisation of securitisation[1].

Thus, securitisation is not just a funding device or an alternative to secured funding: it is a new-found way of lending a tradable character to business relationships, not limited to financial relationships[2]. Asset securitization implies monetisation of advantages, a component which changes over an illiquid money related commitment into an attractive security instrument. By and large, various homogenous money related commitments are pooled together and promoted as tradable instruments like security receipts or Pass through Certificates, generally sponsored by security. At the point when these money related commitments are understood, the cash gathered goes to recover the security receipts.[3]

Consequent upon deepening integration of economics across the world and internationalization of production, our country as well has also become an ever-churning whirlpool of fierce economic competition. The money has started moving over on the account of these pragmatic regulations and there is a need to safeguard its irregularities and the like[4]. Therefore an acute need being felt for providing assistance to the bank and other financial institutions in the recovery of loans particularly those of them which had

become bad and were sub-standard. On account of this, institutions were incurring heavy losses and therefore, there arose a need for regulating securitisation and reconstruction of financial assets and enforcement of security interest. Securitization is comparatively a new concept in India as till 2002, there was no legal framework in India. Therefore in a nutshell, securitisation is sale and purchase of good quality debt and receivables through a Securitisation Company. Thus in a layman's language, Securitization can be defined as conversion of assets of any nature or description into marketable securities, with or without the intervention of some intermediary like a Special Purpose Vehicle (SPV)[5] and issuing those securities to investors. The returns on those securities are paid from the receivables flowing from the assets so securitised[6].

According to the Securities Contracts (Regulation) Amendment Act 2006, "*Securitisation allows banks and financial institutions to keep these loans off their balance sheet, thus reducing the need for additional capital (b) provides banks and financial institutions with alternative forms of funding risk transfer, a new investor base, potential capital relief and capital market development; (c) can reduce lending concentration, improve liquidity and improve access to alternative sources of funding for banks and financial institutions; (d) facilitates attainment of funding at lower cost as a result of isolating the assets of potential bankruptcy risk of the originator; (e) facilitates better matching of assets and liabilities and the development of long-term debt market; (f) provides diversified pool of uniform assets and (g) has the advantage of converting non-investors into liquid assets or marketable securities. Lower funding costs are also a result of movement of investments from less efficient debt markets to more efficient capital markets through the process of securitisation".*

**Background of the 2002 legislation**

The committee on financial system made recommendations of the process of reforms in the financial sector of India starting with the introduction of prudential norms for the banking system and speeding up the process of recovery. With regard to the income recognition, the Committee recommended that banks and financial institutions which are following the accrual system of accounting, no income should be recognized in the accounts in respect of non-performing. An asset would be considered as non-performing if interest on such assets remains due for a period exceeding 180 days at the balance sheet. In the present era banks and financial institutions face considerable difficulties in recovery of dues from the clients and enforcement of security charged to them due to the delays in legal process. Therefore a significant portion of the funds of banks and financial institutions is thus blocked in unproductive assets, the value of which keeps deteriorating with time.

**Narasimham Committee II**- The reform process started in December 1997 when Government decided that it was necessary to review the implementation of financial system reforms recommended by Narasimham Committee and to look ahead and chart the reforms necessary in the years ahead so that India's banking system could become stronger and better equipped to compete effectively in a fast charging international economic environment. The government therefore set up a high level committee under the Chairmanship of Shri. M. Narasimham. This second committee gave its opinion on Banking Sector Reforms and reviewed the implementation of potential banking sector reforms with regard to the Asset Reconstruction Fund and made following observations:
Banks and financial institutions should avoid the practice of "ever-greening" by making fresh advances to their troubled constituents only with a view to settling interest dues and avoiding classification of the loans in question as NPAs. The Committee notes that the regulatory and supervisory authorities are paying particular attention to such breaches in adherence to the spirit of the NPA definitions and are taking appropriate corrective action. At the same time, it is necessary to resist the suggestions made from time to time for a relaxation of the definition of NPAs and the norms in this regard.[7] The Committee was concerned with the mounting dues owned by customers to the banks and financial institutions which affected their financial health. The Committee noted that these financial intermediaries face considerable difficulties in recovering such dues particularly on account of delays in the legal process and endorsed the recommendation of Tiwari committee 1992[8] for setting up special tribunals to expedite the recovery process[9].

The Narasimham Committee also showed considerable concern with regard to the bank's portfolio, "which has already become bad and doubtful and whose recovery is being hampered by the slow legal process", and felt that to keep such assets in the bank's balance sheets would not be desirable even if substantial provisions are made against it. The Committee made a few suggestions in this regard including the setting up of a separate institution known as Asset Reconstruction Fund (ARF) for taking over NPAs (Non-Performing Assets) from banks and recovering them from the primary borrowers[10].

**Legislative aspects**

One of the benefits of Securitisation is specifically the alteration of illiquid credits into liquid securities, it may prompt an increment in the instability of advantage qualities, in spite of the fact that credit improvements could diminish this impact. Besides, the volatility could be enhanced by events extraneous to variations in the credit standing of the borrower. A preponderance of assets with readily ascertained market values could even, in certain circumstances promote liquidation as opposed to going concern concepts for valuing banks[11].

Although the securitisation process has the advantage of enabling lending process to take place beyond the constraints of the capital base of the banking system, the process could lead to a decline in the total capital employed in the banking system, thereby increasing the fragility of the financial system as a whole, both nationally and internationally[12]. The whole concept of securitisation was developed to provide the investors with full control over the security, without restoring the cumbersome security enforcement procedures, where neither the value nor the timeliness was assured. Thus securitisation was seen as a superior secured financing transaction, where the investors have a true ownership of the security. While the concept of securitisation has further developed the essential nature of a majority of transactions remains similar to the secured financing[13]. The benefits for securitization are as follows:-

1. Liquidity- Selling a portfolio results in availability of ready cash.
2. Raise cheaper funds- Securitisation is a cheaper from raising finance for the originator than the traditional forms of debt financing
3. Convert of marketable securities- Assets such as personal loans, residential mortgages, which are not marketable into their original forms, are converted into marketable securities.
4. Transfer of Risk- Transfer of assets to SPV results in transfer to all associated risk, default currency risk etc.
5. In the common parlance there are two sides of securitisation transaction, first is a transfer of assets by the originators to a Special Purpose Vehicle (SPV), which is financed by the SPV by raising funds from the investors, and the second aspect is the appointment of the servicer and provision of credit enhancement to protect the investor. Often the servicer in the transaction continues to be the originator as well as the credit enhancement is provided by the originator. Therefore while the first part of the transaction is akin to ale, the second part ensures that operational control over the assets as well as significant risk/rewards of the assets retained by the originator, which makes it closer to the secured financing transaction, where there are no credit enhancement or if it is provided by an independent third party, who ensures a complete transfer of risk and rewards from the originators balance-sheet and thus it becomes a true sale[14].

**Debts recovery tribunal**

With the growth & development in the global trends in assisting financial institutions to recover their bad debts efficiently and with speedy recovery of pending matters, the Government of India established thirty-three Debts Recovery Tribunals and Five Debts Recovery Appellate Tribunals across the country. The Debts Recovery Tribunal enforces provisions of the Recovery of Debts due to Banks and Financial Institutions (RDDBFI) Act, 1993 whereby the banks could approach the DRT and through the Securitisation and Reconstruction of Financial Assets and Enforcement of security Interests (SARFAESI) Act, 2002 the borrowers, guarantors and any other person aggrieved by any action of the

bank can approach the DRT. The Debts Recovery Tribunals are fully empowered to pass comprehensive orders and can even travel beyond the Civil Procedure Code to render complete justice. However DRT cannot hear claims of damages, deficiency of services breach of contract or criminal negligence on the part of the lenders[15].

The Recovery of Debts due to Banks and Financial Institutions Act, 1993 (RDDBI) has been challenged on various grounds for including the High Courts for its summary nature, the ousting of jurisdiction of civil courts, the provisions which allow the borrowers to proceed against the bank or financial institutions in the Debts Recovery Tribunals, welcomes steps taken by the legislature in ensuring speedy recovery of bank dues. The civil courts are burdened with diverse types of cases. Recovery of Debts due to banks and financial institutions is not given any priority by the civil courts. The banks and financial institutions have to go through a process of pursuing the cases for recovery through civil courts for unduly long periods[16].

The over-riding effect of the Act is stated under Section 34 as: "(1) Save as provided under subsection (2), the provisions of this Act shall have effect notwithstanding anything inconsistent therewith contained in any other law for the time being in force or in any instrument having effect by virtue of any law other than this Act.

(2) The provisions of this Act or the rules made there under shall be in addition to, and not in derogation of, the Industrial Finance Corporation Act, 1948 (15 of 1948), the State Financial Corporations Act, 1951 (63 of 1951), the Unit Trust of India Act, 1963 (52 of 1963), the Industrial Reconstruction Bank of India Act, 1984 (62 of 1984) 2 [the Sick Industrial Companies (Special Provisions) Act, 1985". The constitutional validity of the act was challenged on the grounds of unreasonableness that is violative of Art. 14 of the constitution and that the same is beyond the legislative competence of the parliament.

In *Delhi Bar Assn. V. U.O.I*[17], Hon'ble Delhi High Court held that the DRT could be constituted by the Parliament even though it was not within the purview of Arts.323-A and 323-B of the constitution of India and that the expression 'Administration of Justice' as appearing in List II-A of the seventh schedule to the constitution includes tribunals. It was further laid down by the Supreme Court that '*while Arts. 323-A and 323-B specifically enable the legislature to enact laws for the establishment of tribunals, in relation to the matters specified therein, the powers of the parliament to exact a law constituting a tribunal like a banking tribunal is not taken away*'[18]. The reason behind the ruling of the court is that the recovery of dues is an essential function of any banking institution. Therefore, the parliament can provide the mechanism by which monies due to banks and financial institutions can be recovered.

**Guidelines by the banking regulator**

Securitisation involves pooling of homogeneous assets and the subsequent sale of the cash flows from these asset pools to investors. The securitisation market is primarily intended to redistribute the credit risk away from the originators to a wide spectrum of investors who can bear the risk, thus aiding financial stability and provide an additional source of funding[19]. The Reserve Bank of India having considered it necessary in the public interest and being satisfied that, for the purpose of enabling the Reserve Bank to regulate the financial systems to the advantage of the country and to prevent the affairs of any Securitisation Company or Reconstruction Company from being conducted in a manner detrimental to the interest of investors or any manner prejudicial to the interest of such Securitisation Company or Reconstruction Company, it is necessary to issue the guidelines and directions relating to the registration, measures of asset reconstruction, functions of the company, prudential norms, acquisition of financial assets and matters related thereto. The powers conferred by Sections 3,9,10 and 12 of the SARFAESI Act 2002, issues to every Securitisation Company or Reconstruction Company[20], the guidelines and directions.

According to the RBI guidelines of February-2006, the originators i.e. (Banks/FIs/NBFCs) in a securitisation processare required to amortise any profit/premium arising on securitisation transaction over the life of the securities issued. These guidelines are applicable to securitisation transactions but there are no specific guidelines for income arising on direct assignment transactions. Due to this, many NBFCs were up-fronting the income on premium direct assignment transactions[21].The RBI, on 7th May 2012, has put out the final guidelines on securitisation and direct assignment on account of loan receivables. This was the first initiative taken by RBI that separate guidelines for Direct Assignment transactions wherein they introduced a specific formula for amortization of cash profits for both the types of transactions- securitisation as well as assignment.

**Securitisation in India: the subsequent step**

Securitisation is a process through which illiquid assets are transferred into a more liquid form of assets and distributed to a broad range of investors through capital markets. The lending institution’s assets are removed from its balance sheet and are instead funded by investors through a negotiable financial instrument. The security is backed by expected cash flow from the assets.[22] UK is the second largest market for securitisation after US. Areas of securitisation in the UK are broadly similar to the US and include residential mortgages, credit card, consumer loans, commercial real estate and student loan. The bank of England has played a leading role in evolving guidelines for banking and other authorised institutions in its loan transfers and securitisation.

With an aim to provide a structured platform to the banking sector for managing its mounting NPA stocks and keep pace with international financial institutions, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act was put in place to allow banks and financial institutions to take possession of securities and sell them[23]. As stated in the Act, "It has enabled banks and financial institutions to realise long-term assets, manage problems of liquidity mismatches and improve recovery by taking possession of securities, sell them and reduce non-performing assets (NPA) by adopting measures for recovery or reconstruction." Prior to the Act, the legal framework relating to commercial transactions lagged behind the rapidly changing commercial practices and financial sector reforms, which led to a low recovery of defaulting loans and mounting levels of NPAs of banks and financial institutions[24]. The new Act allows secured lenders to sell assets, which are charged with them by defaulting borrower without protracted legal tussle.

- Non-performing asset mean an asset which has been classified by the bank or FIs as substandard, doubtful or loss asset, in accordance with the direction to asset clarification issued by RBI.
- This Act required 60 days notice to be given to the defaulter. The notice has to be very specific.
- On receiving the notice, no borrower can sell, lease or transfer the secured assets mentioned in the notice, without the lender's notice.
- No injunction shall be granted by any civil court or other authority in respect of action taken under this Act.

**Comparative study between India and USA**

Securitisation is a well-established practice in the global debt capital markets. It was introduced initially as a means of funding for US mortgage banks. Subsequently, the technique was applied to other assets such as credit card payments and leasing receivables. It has also been employed as part of asset/liability management, as a means of managing balance sheet risk[25]. It is true that the process of securitisation creates asset backed bonds, they can be termed as debt instruments that has been created from a package of loan on which the interest is payable. The diversification in the market with a wide range of instruments developed the large asset-backed market of USA. Bond creation on residential mortgages, car loans and credit card loans can be done with the help of new technologies employed by the investment banks. These loans form assets on a bank or financial institution when they are packed together and are used as bonds.

The driving force behind the process of securitisation is that there is a need for the banks to realise the value on their balance sheet, generally these assets include residential mortgages, corporate loans and other retail loans one of such example is the credit card

loans. In USA a bank may wish to reduce the size of the balance sheet for the following reasons:
1. If the revenues received from the assets remain roughly unchanged but the size of assets has decreased, this will lead to an increase in the return on equity ratio;
2. The level of capital required to support the balance sheet will be reduced, which again can lead to cost savings or allows the institution to allocate the capital to other perhaps more profitable business;
3. To obtain cheaper funding: frequently the interest payable on ABS securities is considerably below the level payable on the underlying loans. This creates a cash surplus for the originating entity.

The process of reforms in the commercial laws started in United States of America with the introduction of the Uniform Commercial Code (UCC). While one of the main objectives of the reform in legal system in the USA was to make the law uniform for the whole country and make the states adopt the Uniform Model code, the uniform commercial has also introduced certain new concepts for facilitating trade, commerce and creation of security interests over movable properties and enforcement of such security interests.

**Reforms required in SARFAESI Act, 2002**

The SARFAESI Act is focuses on default and enforcement and the law needs to be revised to make it comprehensive on security interest. The other reforms required in the Indian context are listed below:
1. Make the law universally applicable to all secured creditors and not simply to the banks and financial institutions,
2. Segregate provisions relating to securitisation from the Act and enact a separate law for securitisation of financial assets.
3. Extend SARFAESI Act to financial leases, hire-purchase and sales on credit transactions
4. Set up a Central Electronic Registry for registration of charges on movables and integrate some existing registration systems such as the one under the Companies Act, 1956 with the new registry.

**Recommendations**

It was world renowned economist John Maynard Keynes (1930) who pioneered the precise definition of the term “liquidity” in Macroeconomics, and pointed out its inarguable significance in any given financial market of the world. Keynes wrote that an asset is said to be liquid if “it is more certainly realizable at a short notice without loss”[26]. Liquidity has been one of the healthiest symptoms of an economy and firms worldwide. It

is also the most sought after dream of money lenders and investors alike. It is a common thread that binds money chaser irrespective of the geographical foundations and the securitisation is a kind of process that helps them to realise this dream. Through this process of securitisation, the illiquid assets of a company are transferred or converted into a more suitable and desirable liquid form consisting of numerous assets, that are distributed or sold to the investors through the medium of Capital Markets. The result of this is that Non-performing Assets (NPSs) of a company are transferred into easy flowing cash funds/liquidity.

Security implies financial claim is in a form of document with ensured marketability in the context of securitisation. This ensures that marketability comes from the determined. Thus the receivables are replaced by cash inflows thereby improving the liquidity position of the originator, i.e. the company initially having NPAs stuck in its balance sheet. The securitisation can be determined as a process that involves pooling of homogenous illiquid financial assets into securities that are marketable to investors who are known as the Originators. These pools of assets are handed over to a Special Purpose Vehicle (SPV). According to the Indian Companies Act 2013 an SPV is created in the same manner in which a company is created, in the common parlance it is created as a trust. The SPV then issues asset-backed commercial papers or securities in the form of debt or marketable instruments. To boost up the investor'sconfidence, the assets are rated by the Credit Rating Agencies so that the entire market gets a security. Any asset that has cash flow profile over a period of time can be securitized, some of such examples are housing loans, car loans, credit card payments, ticket sales, electricity and even phone bills and receivables. The word securitisation was given a shape in the year 2002 with the enactment of the SARFAESI Act, 2002. Further, the Act was challenged inMardia Chemicals versus ICICI Bank and other financial institutions had initiated legal proceedings under the said act. Section 17(2) of the same Act was the sole provision which could prevent the defaulting companies from approaching the court or the tribunal on frivolous grounds however, there is another clause that states that the borrowers have the right to go to the DRT without depositing 75 % of the outstanding loans and the lending bank can only go ahead and sell off the assets in the absence of any stay order from the tribunal. At present it has become very much easy for anyone and everyone to file appeal with the DRT for buying some time and passing of an interim order in favour of the borrower who may deplete the value of the assets further. It will also give a free hand to the borrowers to tamper with the assets. If we look into the historical perspective, DRT has not been effective in recovering the debts from the market. There is a large accumulation of cases pending before the DRT and the adjudication is a time intense process. The most likeable aspect is that DRT will not be able to handle the estimatedflood of cases that are likely to be filed in the Supreme Court and the Bankers and Financial Institution will again have to face the similar differences.

Though the Supreme Court has not fully met with the expectations of lenders, this verdict will be viewed positively. Before passing this judgment, there was much ambiguity about the true scope and implementation of the Act but now even the lenders can negotiate with the defaulters on a better balance. At least with the upholding of the Act the banks now have the right to seize and sell all the assets. The Supreme Court Rulings should realize the basic objective with which the Act was drafted. There is a possibility that due to the absence of section 17(2) the pace of recovery will be slower as compared to what would happen if the section is in force. But definitely recovery process would be still a lot faster than was possible before passing of this Act.

The Act has also confined the definition of "Financial Assets" (Section 2(1)) that can be securitized. Further, only banks and financial institutions (FIs) can securitize their assets thereby restricting the role of 'originators'. As investor is an entity who buys the securitized instrument. Only qualified institutional buyers are to invest in the security receipts, as per Section 7(1) of the Act. Thus even the players in the securitised market are restricted. This means that in Indian markets, it is simply not possible to securitize assets and receivables from credit cards, sale of tickets, car rentals and export earnings, the credit goes to the limited parameters of the Act. This gives the institutional markets an edge over India's NPA.

Notwithstanding the revolutionary implications of securitisation in the financial markets the legal constraints of the same cannot be overlooked. One such major constraint is the stamp duty. When the financial asset is transferred from the originator to the SPV, the relevant provisions of the stamp Act work on three stages. One, when the SPV acquired the financial assets from the originator, second, when the Security Receipts are created and finally when the Security Receipts are transferred from one investor to another unless if it is a *demat* form. Especially in India, stamp duty is a major hurdle. Different states charge variable slabs of Stamp Duty ranging anywhere from 4% to 12%. Only four states in India such as Maharashtra, Tamil Nadu, Gujarat and West Bengal have recognised the commercial benefits of the securities and thereby reduced the stamp duty on such transactions. This is definitely an applaudable step.

The Act has definitely initiated a smooth way for the development of financial market in India, save for restrictive measures. The market securitisation is restricted inasmuch that the Originators and the SPVs, as well as the financial assets are also confine by the Act. However, law makers argue that this is to enable only the more stable investors to play safe in the world of securitisation. However, with the increasing instance of this phenomenon in the Indian market, the other players will be given their own share of fair chance. India has always played safe even with the issuance of the traditional commercial paper, so a cautious mode of policy in dynamic phenomenon like securitisation comes as no surprise.

One of the most far reaching implications of securitisation, is that it has accounted for a more stringent policy for debt recovery on India where traditionally, the same has been a long and difficult process. The Securitisation Act, 2002 paves the way for the speedy recovery of debts to banks and financial institutions by giving a 60 days' notice of default. This would improve capital liquidity by cutting down on losses from irrecoverable debt.

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